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Mapping the New Normal

Chinese Airlines and Airports: Still in Turbulence

A slower than expected recovery in outbound travel would lead to structural changes to China's aviation industry. We downgrade Chinese airlines and SIAC with a more conservative earnings outlook.

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Mapping the New Normal

Chinese Airlines and Airports: Still in Turbulence

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Industry View

Hong Kong/China Transportation & Infrastructure — In-Line

The new normal for China air travel: Combined with key observations from our AlphaWise travel survey in China conducted during July & August 2020, we see several new normals that may impact China's aviation industry: 1) willingness to travel has softened across the board; 2) a higher tendency to travel domestically instead of outbound; 3) lower travelling and shopping budgets due mainly to household expense cuts.

Implications for airlines and airports: We think this new environment is: 1) negative for airlines, and airports with higher profit contribution from duty-free sales; 2) less negative for players with higher domestic travel exposure, as well as for low cost carriers (LCCs); 3) positive for Hainan Meilan Airport with higher exposure to domestic duty free business.

The new normal for airlines – sustained price-based competition led by oversupply. We see an oversupply for Chinese airlines in terms of capacity as well as available airport slots. 20-30% of total air traffic demand comes from non-domestic travel, which may not fully recover in the next 12-18 months, and airlines and airports are encouraged by CAAC to shift capacity back to the domestic market. We see a high probability of a price war among airlines, given a relatively fragmented supply and a low probability of fast consolidation.

The new normal for airports – duty free not recovering anytime soon. Amid international flight restrictions, we expect Chinese airports to see sizable revenue decline due to disruption of duty free store operations in the next 9-12 months. In the longer term, we are concerned that SIAC/BCIA/GBIA will no longer be proxies for China's duty free consumption, given dilution in other emerging duty free shopping channels.

Downgrade Big 3 airlines and Shanghai Airport: We downgrade the A and H shares of the Big 3 airlines – Air China, China Eastern and China Southern –and SIAC, with our more bearish earnings outlook. We think the market has not priced in: 1) worse than expected book erosion for airlines; and 2) downside risks to medium-term duty free evolution for airports. HMIA, Travelsky and Spring Airlines are our most favored names in aviation-related names, while the Big 3 A-shares, CEA H shares, CPA and BCIA, are our least favored names.

Upside risks to our view: 1) a faster than expected recovery in international travel; 2) new CAAC policy to tighten the supply side for airlines; 3) airlines industry consolidation; 4) capital injections to airlines by the government move beyond our current expectation.

Exhibit 1:

What's Changed – see today's Chinese Airlines and Airports: More Conservative Assumptions on Non-domestic Traffic for details

	Ticker	Rating	Currency	New PT	Old PT	PT Chg	Share Price	Upside
Air China Limited - H	0753.HK	EW	HKD	5.12	NA	NA	5.27	-3%
Air China Limited - A	601111.SS	UW	Rmb	5.64	NA	NA	7.30	-23%
China Eastern Airlines - H	0670.HK	↓ UW	HKD	2.50	3.60	-31%	2.99	-16%
China Eastern Airlines - A	600115.SS	↓ UW	Rmb	2.87	4.11	-30%	4.92	-42%
China Southern Airlines - H	1055.HK	↓ EW	HKD	3.58	4.39	-18%	3.86	-7%
China Southern Airlines - A	600029.SS	↓ UW	Rmb	4.08	5.78	-29%	5.80	-30%
Spring Airlines	601021.SS	OW	Rmb	50.40	46.40	9%	44.42	13%
Juneyao Airlines	603885.SS	EW	Rmb	9.71	9.44	3%	10.63	-9%
Cathay Pacific Airways	0293.HK	UW	HKD	5.00	NA	NA	5.57	-10%
Airlines Average						-16%		-14%
Beijing Capital Int'l Airport	0694.HK	UW	HKD	4.70	5.40	-13%	5.54	-15%
Shanghai International Airport	600009.SS	↓ EW	Rmb	69.00	80.20	-14%	74.38	-7%
Guangzhou Baiyun Int'l Airport	600004.SS	EW	Rmb	14.10	14.30	-1%	15.03	-6%
Shenzhen Airport Company	000089.SZ	EW	Rmb	9.30	8.90	4%	10.17	-9%
Hainan Meilan International Airport	0357.HK	OW	HKD	61.00	61.00	0%	46.90	30%
Airports Average						-5%		-1%
TravelSky Technology	0696.HK	OW	HKD	17.20	19.40	-11%	15.62	10%

Source: Morgan Stanley Research (E) estimates, Refinitiv

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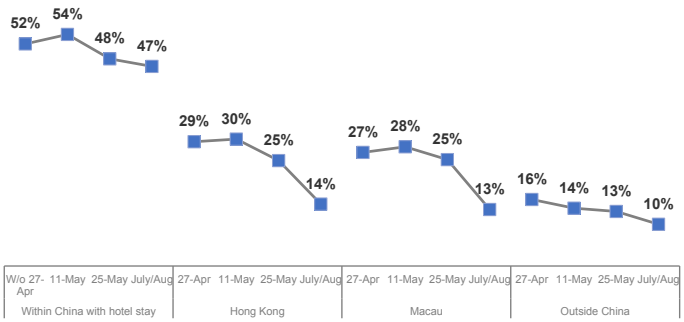
30 Implications for the China Duty Free Market

Key Charts

Exhibit 2:

Travel willingness falls

Take Next Leisure Trip in the next 6 months

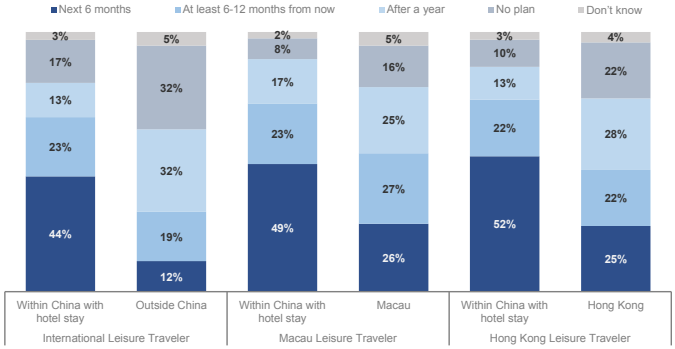


Source: AlphaWise, Morgan Stanley Research

Exhibit 3:

The new normal is travelling within China instead of overseas

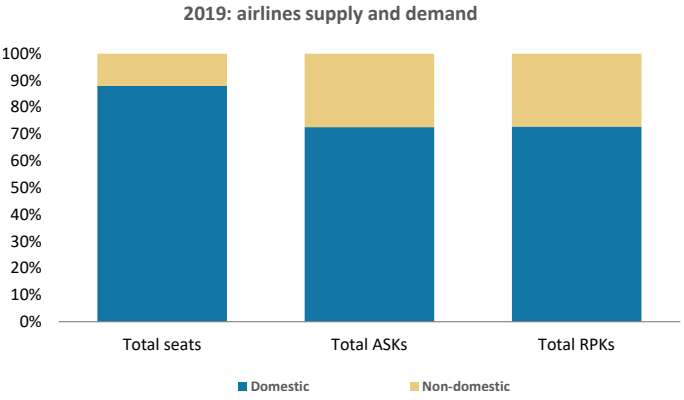
Time Frame to Take Next Leisure Trip by Traveller Type



Source: AlphaWise, Morgan Stanley Research

Exhibit 4:

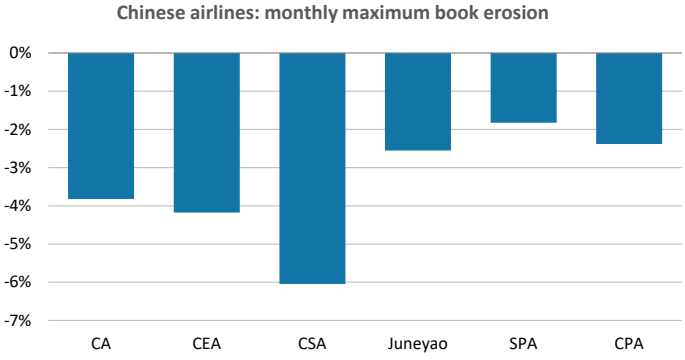
20-30% supply can move from non-domestic routes to domestic



Source: CEIC, Morgan Stanley Research

Exhibit 5:

Chinese airline net book value could drop by 2-6% every month assuming maximum loss making



Source: Morgan Stanley Research estimates

Exhibit 6:

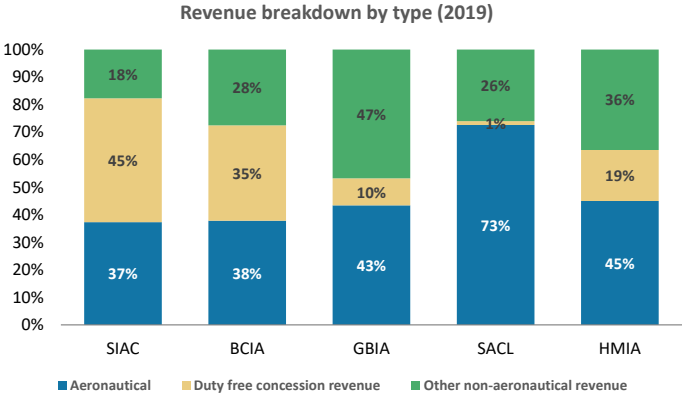
Duty-free/airport shops remain top shopping destinations for next trip

Likely Shopping Destination for Next Trip by Total

Source: AlphaWise, Morgan Stanley Research

Exhibit 7:

Duty free is an important source of revenue for Chinese airports



Source: Company data, Morgan Stanley Research

Executive Summary

The new normal of air travel

How has air traffic been recovering?

China's domestic air traffic has been recovering after the trough in February. In July 2020, domestic pax volume index has recovered to 74% of last year's level, according to TravelSky. However, international volume index was down 98% YoY. Passenger load factor recovered to 70.3% in June 2020 after a trough of 50% in February, however, it is still much lower than 83.3% in June 2019.

Our expectation on demand recovery

Our China economists expect that growth will return to potential (~6% YoY) by 4Q20, reaching an above-consensus 2% YoY in 2020 overall. On the air traffic side, we expect:

- The recovery on the domestic market to continue, to a positive 5% YoY growth in 4Q20, while in 2021 grow to 10% above 2019 level;
- For international traffic, we expect the YoY drop to slightly narrow to -90% YoY in 4Q20, from over 95% YoY drop now, and further recover to ~50% of 2019's level in 2021.

Key takeaways from our AlphaWise survey

We surveyed 2,667 Chinese residents living in Tier 1-3 cities during July to August 2020 using online interviews, with 1989 being travelers. The margin of error for findings on the total sample is ±1.5% at 90% confidence level and higher for subgroups.

We conclude several potential new normals from the survey:

1. Travel sentiment has decreased from May 2020's level
2. Higher tendency to travel within China versus outbound
3. Slightly higher business trip intentions versus leisure within six months
4. A lower budget leading to shopping expenses cuts
5. Duty free shops are the most preferred shopping venues

Airlines: A more bearish earnings outlook

The supply side story no longer valid

We used to be bullish on airlines, mainly for the following reasons

- There is a supply-side tightness in the domestic market, due mainly to the airport slot growth controls by CAAC, as well as airports' willingness to allocate more slots to non-domestic routes;
- The air ticket price reforms: Chinese airlines are allowed to hike prices on selected routes twice every year;
- Higher load factors in the domestic market should lead to better domestic profitability, while Chinese airlines generate a majority of their profits from the domestic market.

However, we think the story has changed due to COVID-19. CAAC now encourages airlines to shift unused international slots back to the domestic market, potentially leading to oversupply.

A potential oversupply in 2020 -2021

In 2019, non-domestic supply represented ~27% of total air market in terms of available seat kilometers. Airport non-domestic slots also accounted for ~22% of total slots in the same year. Therefore, if these slots are all put to the domestic routes, there will be ~25% higher domestic slot supply on 2019's airport capacity.

A price war is highly likely

We think a price war is highly likely in China's airlines industry, given:

- There is a low marginal cost for one extra seat sold on an airplane.
- Airlines' services are close to perfect substitutes for each other.
- Market concentration is not high enough – there were more than 60 airlines in China in 2019.
- Consolidation is difficult, given ~48 airlines are owned by central or local governments.
- Airlines have already started to sell low price ticket packages which appears to be a price war product.

We turn more bearish on airlines

We see limited earnings upside albeit with a strong domestic traffic recovery, due mainly to pricing pressure. We expect Chinese airline book values to drop by a maximum 2-6% every single month, if pricing stays depressed.

We expect the Big 3 airlines' book values to drop by 17% to 23% in 2020, and another 6% to 11% in 2021, without considering asset injections or share issuances. Our earnings forecasts are significantly below consensus for the Big 3.

We cut our price targets by an average of 16% for Chinese airlines.

Airports: Short-term Headwinds and Changes to the Long-term Story

Short-term losses due to reliance on international traffic

Chinese airport revenue is highly dependent on international flights and passenger traffic. Therefore, given the likely >80% YoY decline of international traffic in full-year 2020, we expect SIAC, BCIA, GBIA and SACL to see sizable revenue declines in 2020. As fixed costs (labor costs, rental, depreciation, etc) represent roughly 70% of overall operating costs for airports, the big-ticket revenue decline will result in significant negative operating leverage.

In addition, we also see uncertainties in duty free guaranteed rent negotiations which should happen between airports and China Tourism Group Duty Free (CTGDF, 601888.SS) in 4Q20. The market expects that airports can get ~50% of the contracted guaranteed rent. However, we think it will be difficult for airports to justify such a claim, because the airport duty free store sales collapse is caused by the global COVID-19 pandemic which is a *force majeure* situation rather than the responsibility of CTGDF.

Long-term growth potential discount by duty free sector evolution

Since 2017, the airport sector has become a proxy for China's duty free consumption growth, with robust earnings growth and valuation re-rating. However, the travel ban associated with the COVID-19 pandemic has triggered several new developments in the duty free sector in 1H20 (see Mapping the New Normal: China's Duty-Free Evolution (8 Jun 2020)). In the future, airport duty free stores face dilution from other emerging duty free shopping channels, such as online, Hainan Island, downtown duty free malls, etc. We therefore expect airports (in particular SIAC and GBIA) to shift from being a high growth story to investments with stable growth, asset-heavy business model, high margin and rich cash flow. Potential valuation de-rating may also happen for airport stocks, from previous 25-30x P/E to 20-25x range.

The only airport is not hurt by the ongoing duty free evolution is Meilan Airport (HMIA), which is our top pick within the airport sector. Please read: Hainan Meilan International Airport: Marching on the growth track with eased dilution risk (31 Jul 2020).

Downgrade Airlines and Shanghai Airport

What's in the price?

Airlines: Potential downside to consensus earnings forecasts are not in the price

A and H share airlines stocks have recorded 17% and 30% average share price decline YTD, respectively, significantly underperforming the +13% and -10% of the Shanghai Composite Index and Hang Seng Index, respectively. We think this has only partially priced in the sizable loss-making and cash burn due to the COVID-19 pandemic, as our earnings forecasts for 2020 and 2021 imply 9ppt and 12ppt lower ROE for 2020 and 2021, respectively, versus consensus (based on 2019 BPS).

In our view, the market has not yet considered the downside risks for 2021-22 of oversupply for domestic routes and associated price war among airlines, as vacant international slots will be used for domestic routes.

Airports: the market has priced in 2021e earnings but not yet medium-term risk duty free evolution

Year-to-date, A-share listed airports, SIAC/GBIA/SACL, have recorded -6%/-14%/4% share price returns, underperforming the 13% increases in Shanghai Composite Index. Similarly, BCIA's share price has dropped by 27% YoY, also lagging behind the 10% drop in the Hang Seng Index. We think market has priced in the negative earnings impact from the COVID-19 pandemic on airport companies in 2021e. However, we think the market might have been over-optimistic about airports' 2021e earnings. In addition, the medium term downside risks in duty free operations are not yet priced in, in our view.

Airlines: Downgrade Big 3 A and H shares

We are more bearish versus the market, due mainly to our more conservative outlook on the non-domestic recovery. With more supply crowded into China's domestic market, it is likely Chinese airlines are getting into a price-based competition and will stay loss making for a longer than previously expected period. We expect the Big 3 airlines to stay loss making in 2H20 and 1H21, with 25-35% book erosion over these two years.

We have EW ratings on both Air China H and China Southern H (downgraded from OW), and downgrade China Eastern H to UW; we now rate the Big 3 A shares at UW.

Downgrade Shanghai Airport to EW

We downgrade Shanghai Airport from OW to EW, considering: (1) short-term earnings pressure given high dependence on international traffic (51% of traffic in 2019) and duty free revenue (45% of 2019 revenue); and (2) structural change in its growth story given the evolution in the duty free sector.

Upside risks to our views

We see potential upside to our conservative view towards Chinese airlines and airports, if there is: 1) faster than expected recovery in international travel; 2) new CAAC policy to tighten the supply side for airlines; 3) airlines industry consolidation; or 4) capital injection to airlines by the government beyond expectation.

Our top picks

We relative prefer Travelsky and Spring Airlines in airlines and related services. We like Travelsky for its relatively higher margins versus airlines and higher revenue exposure to domestic travel; we like Spring Airlines relative to other airlines, given our positive view towards its aggressive market share expansion with Covid-19 disruptions.

Among our Chinese airport coverage, HMIA remains our top pick, followed by GBIA, SIAC then SACL. BCIA remains our least preferred.

Order of Preference

Exhibit 8:

Industry Order of Preference

	HMIA 0357.HK	TravelSky 0696.HK	Spring Airlines 601021.SS	SACL 000089.SZ	SIAC 600009.SS	GBIA 600004.SS	Juneyao Airlines 603885.SS	AirChina-H 0753.HK	CSA-H 1055.HK	BCIA 0694.HK	Cathay Pacific 0293.HK	CEA-H 0670.HK	AirChina-A 601111.SS	CSA-A 600029.SS	CEA-A 600115.SS
Rating	Overweight	Overweight	Overweight	Equal-weight	Equal-weight	Equal-Weight	Equal-Weight	Equal-weight	Equal-weight	Underweight	Underweight	Underweight	Underweight	Underweight	Underweight
Trading Currency	HKD	HKD	CNY	CNY	CNY	CNY	CNY	HKD	HKD	HKD	HKD	HKD	CNY	CNY	CNY
Price Target	**61.00**	**17.20**	**50.40**	**9.30**	**69.00**	**14.10**	**9.71**	**5.12**	**3.58**	**4.70**	**5.00**	**2.50**	**5.64**	**4.08**	**2.87**
Current Price	46.90	15.62	44.42	10.17	74.38	15.03	10.63	5.27	3.86	5.54	5.57	2.99	7.30	5.80	4.92
Upside/(Downside) (%)	30%	10%	13%	-9%	-7%	-6%	-9%	-3%	-7%	-15%	-10%	-16%	-23%	-30%	-42%
Market Cap (in USD mm)	2,863.4	5,897.2	5,860.1	3,000.9	20,622.3	4,475.0	3,007.2	13,566.0	11,354.0	3,273.1	4,626.5	9,927.5	13,566.0	11,354.0	9,927.5
Avg Daily Traded Vol (in USD mm)	2.5	8.5	33.6	32.8	131.6	44.7	23.3	16.7	12.4	9.4	6.5	6.9	61.2	47.4	31.9
Street View: Ratings															
Buy/Overweight	75%	83%	92%	60%	91%	75%	73%	85%	88%	35%	17%	95%	75%	53%	74%
Hold/Equal-weight	25%	8%	8%	33%	4%	19%	27%	15%	13%	47%	67%	5%	25%	40%	21%
Sell/Underweight	0%	8%	0%	7%	4%	6%	0%	0%	0%	18%	17%	0%	0%	7%	5%
Bull Case Value	85.00	20.80	106.71	13.40	96.00	20.00	15.83	7.83	5.28	8.00	10.00	4.03	9.83	7.58	5.79
Upside (%)	81%	33%	140%	32%	29%	33%	49%	49%	37%	44%	80%	35%	35%	31%	18%
Bear Case Value	25.00	7.50	30.06	5.80	44.00	5.00	4.11	2.80	2.20	2.80	3.60	1.35	2.51	1.97	1.21
Downside (%)	-47%	-52%	-32%	-43%	-41%	-67%	-61%	-47%	-43%	-49%	-35%	-55%	-66%	-66%	-75%
Risk/Reward Skew	1.7	0.6	4.3	0.7	0.7	0.5	0.8	1.0	0.9	0.9	2.2	0.6	0.5	0.5	0.2
Morgan Stanley Estimates															
FY20e	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	HKD	CNY	CNY	CNY	CNY
Sales	1,194	5,291	9,500	2,971	4,711	5,994	10,283	68,146	86,351	4,179	51,474	65,357	68,146	86,351	65,357
EBITDA	644	932	1,283	673	1,393	1,833	(255)	7,236	15,364	496	(8,625)	13,097	7,236	15,364	13,097
EBIT	472	(9)	278	201	183	156	(1,081)	(17,236)	(11,425)	(964)	(18,223)	(13,596)	(17,236)	(11,425)	(13,596)
EPS	0.73	0.14	0.20	0.08	0.45	0.10	(0.42)	(1.10)	(0.81)	(0.25)	(4.23)	(0.96)	(1.10)	(0.82)	(0.96)
FY21e															
Sales	2,265	7,941	13,618	4,045	8,643	7,647	16,634	117,871	140,820	7,302	74,544	112,667	117,871	140,820	112,667
EBITDA	1,380	3,083	2,831	1,354	4,815	2,662	1,732	24,741	26,223	2,509	3,651	27,069	24,741	26,223	27,069
EBIT	1,001	2,064	1,582	808	3,560	982	724	(4,557)	(2,867)	993	(6,310)	(2,132)	(4,557)	(2,867)	(2,132)
EPS	1.50	0.70	1.19	0.28	1.86	0.40	0.25	(0.32)	(0.30)	0.13	(1.49)	(0.36)	(0.31)	(0.30)	(0.36)
FY20 MSe vs. Consensus Mean															
Sales	-7.3%	-14.2%	-9.6%	-7.5%	-41.0%	0.8%	-20.3%	-26.4%	-14.3%	-42.3%	-1.4%	-19.6%	-24.9%	-13.8%	-18.9%
EBITDA	-16.4%	-44.0%	7.0%	3.5%	-56.8%	11.9%	-120.7%	-65.1%	-14.6%	-75.9%	-362.7%	-26.6%	-53.9%	-17.1%	-17.6%
EBIT	-8.4%	-101.0%	-684.0%	-8.1%	-90.6%	68.6%	-4142.4%	2622.3%	146.6%	-262.0%	85.9%	420.5%	300.0%	87.5%	155.2%
EPS	-8.1%	-62.8%	-49.0%	-19.6%	-59.4%	14.6%	-946.7%	249.7%	62.0%	-373.1%	59.6%	158.6%	175.5%	51.6%	142.8%
FY21 MSe vs. Consensus Mean															
Sales	10.2%	-6.9%	-19.6%	-7.1%	-31.6%	-11.1%	-12.6%	-13.5%	-4.9%	-14.3%	-6.5%	-7.6%	-16.5%	-7.8%	-12.3%
EBITDA	2.7%	-6.5%	-26.0%	3.2%	-34.2%	-15.0%	-42.3%	-32.8%	-26.4%	-8.9%	-75.6%	-17.5%	-26.9%	-24.6%	-12.6%
EBIT	37.2%	-17.6%	-35.5%	4.2%	-37.7%	-33.8%	-58.0%	-132.6%	-128.7%	-26.8%	-649.4%	-118.3%	-134.0%	-126.3%	-120.1%
EPS	39.1%	-19.1%	-50.6%	-11.2%	-33.2%	-25.8%	-66.5%	-162.7%	-204.9%	-37.6%	944.1%	-236.7%	-158.7%	-170.6%	-203.1%
Valuation Multiples at Last Close															
FY20e															
P/E	57.9x	100.6x	227.4x	126.5x	166.4x	154.3x	-25.1x	-4.3x	-4.3x	-20.2x	-1.3x	-2.8x	-6.6x	-7.1x	-5.1x
EV/EBIT	45.8x	-3466.5x	174.2x	105.0x	734.7x	189.6x	-31.4x	-16.9x	-14.9x	-27.7x	-6.4x	-20.2x	-16.9x	-14.9x	-20.2x
EV/EBITDA	33.5x	35.2x	37.8x	31.3x	96.6x	16.1x	-133.2x	40.3x	11.1x	54.0x	-13.5x	21.0x	40.3x	11.1x	21.0x
EV/Sales	18.1x	6.2x	5.1x	7.1x	28.6x	4.9x	3.3x	4.3x	2.0x	6.4x	2.3x	4.2x	4.3x	2.0x	4.2x
FCF Yield	-10.6%	2.3%	-9.5%	-12.6%	0.2%	4.9%	-3.7%	-16.7%	-12.9%	-11.6%	-82.6%	-54.1%	-16.7%	-12.9%	-54.1%
FY21e															
P/E	28.1x	20.1x	37.2x	36.6x	39.9x	37.6x	41.7x	-15.0x	-11.5x	37.4x	-3.7x	-7.4x	-23.2x	-19.0x	-13.6x
EV/EBIT	21.0x	15.5x	32.7x	27.4x	37.0x	28.7x	48.2x	-73.8x	-64.9x	26.3x	-20.9x	-124.3x	-73.8x	-64.9x	-124.3x
EV/EBITDA	15.2x	10.4x	18.3x	16.4x	27.4x	10.6x	20.2x	13.6x	7.1x	10.4x	36.1x	9.8x	13.6x	7.1x	9.8x
EV/Sales	9.3x	4.0x	3.8x	5.5x	15.3x	3.7x	2.1x	2.9x	1.3x	3.6x	1.8x	2.4x	2.9x	1.3x	2.4x
FCF Yield	4.4%	3.4%	-5.9%	-4.4%	2.3%	4.9%	-0.1%	-5.6%	6.8%	3.2%	-42.1%	3.8%	-5.6%	6.8%	3.8%
Implied Multiples on MS Price Target															
FY20e															
P/E	75.3x	110.7x	258.1x	115.7x	154.3x	144.7x	-22.9x	-4.2x	-4.0x	-17.1x	-1.2x	-2.3x	-5.1x	-5.0x	-3.0x
EV/EBIT	58.5	-3904.9	193.9	96.2	678.1	177.3	-29.7	-12.7	-7.0	-24.2	-6.2	-16.0	-14.7	-9.7	-17.5
EV/EBITDA	42.8	39.6	42.1	28.7	89.2	15.1	-126.1	30.1	5.2	47.0	-13.1	16.6	35.0	7.2	18.2
EV/Sales	23.1	7.0	5.7	6.5	26.4	4.6	3.1	3.2	0.9	5.6	2.2	3.3	3.7	1.3	3.6
FY21e															
P/E	36.5x	22.2x	42.2x	33.4x	37.1x	35.3x	38.1x	-14.5x	-10.7x	31.7x	-3.3x	-6.2x	-17.9x	-13.4x	-7.9x
EV/EBIT	28.7	24.7	32.9	27.4	43.2	34.3	30.5	-7.6	-8.8	22.7	-5.8	-10.1	-15.3	-19.7	-19.8
EV/EBITDA	20.8	16.6	18.4	16.3	31.9	12.7	12.8	1.4	1.0	9.0	10.1	0.8	2.8	2.2	1.6
EV/Sales	12.7	6.4	3.8	5.5	17.8	4.4	1.3	0.3	0.2	3.1	0.5	0.2	0.6	0.4	0.4
Stock Price Performance															
1 Month	17.3%	11.3%	15.6%	13.1%	4.0%	1.3%	10.5%	10.7%	8.4%	3.7%	(7.5%)	6.8%	4.9%	7.0%	11.6%
3 Month	485.5%	22.6%	32.6%	31.9%	13.4%	9.7%	16.2%	9.8%	17.0%	14.0%	(27.7%)	9.5%	9.4%	13.9%	19.4%
1 Year	879.1%	7.0%	3.2%	3.5%	(12.3%)	(17.3%)	(13.6%)	(21.2%)	(15.9%)	(7.8%)	(39.7%)	(20.1%)	(7.5%)	(13.2%)	(4.3%)
YTD	748.1%	(17.9%)	1.2%	4.1%	(5.5%)	(13.9%)	(29.1%)	(33.4%)	(26.3%)	(26.6%)	(44.5%)	(30.8%)	(24.7%)	(19.2%)	(15.3%)

Source: Morgan Stanley Research, Refinitiv (consensus mean). e = Morgan Stanley Research estimates

Note: Past performance is no guarantee of future results. Results shown do not include transaction costs.

AlphaWise Survey – The New Normal for Travel

We surveyed 2,667 Chinese residents living Tier 1-3 cities during July to August 2020 using online interviews, with 1989 being travelers. The margin of error for findings on the total sample is ±1.5% at 90% confidence level and higher for subgroups.

We conclude several potential new normals from the survey:

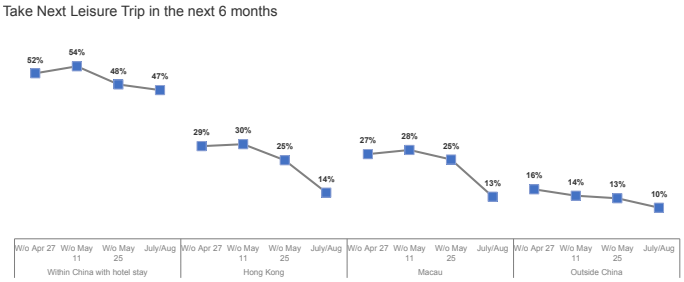
1. Travel sentiment has been decreasing, especially on non-domestic routes, due mainly to concerns over COVID-19.
2. Higher tendency to travel within China versus outbound – over 60% of respondents are not considering outbound travel within one year, versus ~30% for a domestic trip.
3. Slightly higher business trip intentions versus leisure within six months.
4. A lower budget due mainly to expected shopping expenses cuts.
5. Some evidence hinting at a positive outlook for Hainan Meilan International Airport's (HMIA) duty free operation.
6. Airline travellers care more about time slots, services, direct flight, as well as lower ticket prices.

Intention to travel has dropped in July-Aug versus May 2020...

Intention to travel within mainland China in the next six months is the highest at 47%, followed by Hong Kong (14%), Macau (13%) and lastly outside China (10%). Compared to our China snapshot survey conducted in April/May 2020, near-term mainland China travel intentions with a stay in hotels slightly dropped, while intentions to visit HK/Macau almost halved.

Exhibit 9:

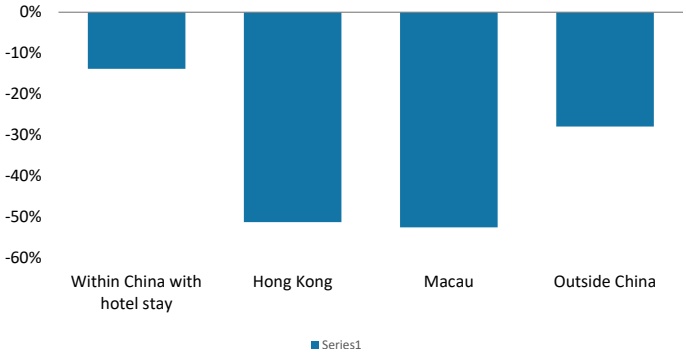
Travel willingness falls...



Source: AlphaWise, Morgan Stanley Research

Exhibit 10:

...especially for HK, Macau and Outside China



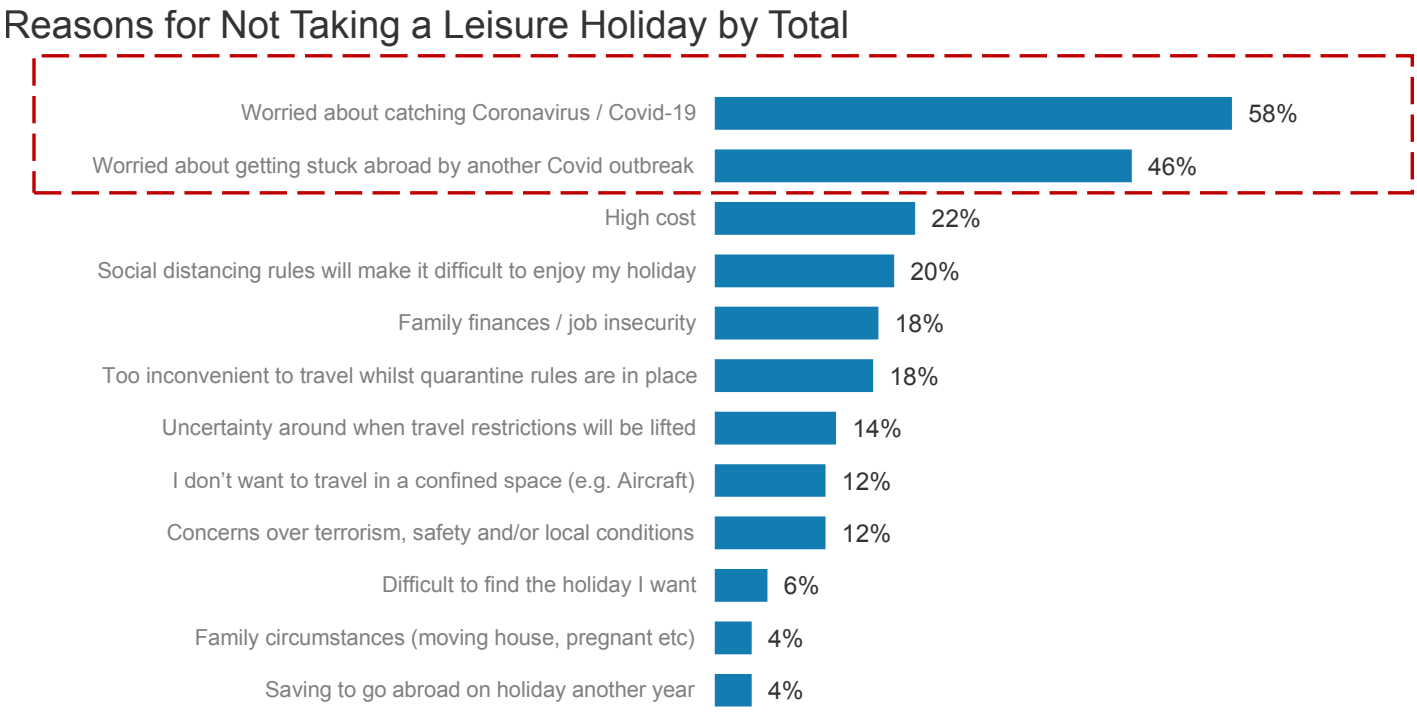
Source: AlphaWise, Morgan Stanley Research

...with concerns from COVID-19

Amongst the long list of reasons preventing a leisure trip, 58%/46% respondents cited concerns over catching COVID-19/getting stuck abroad due to a COVID outbreak. In addition, 22%/18% respondents mentioned difficulties to travel due to social distancing/quarantine rules.

Exhibit 11:

COVID concerns remain the major reason preventing leisure travel


Reasons for Not Taking a Leisure Holiday by Total
Worried about catching Coronavirus / Covid-19
58%
Worried about getting stuck abroad by another Covid outbreak
46%
High cost
22%
Social distancing rules will make it difficult to enjoy my holiday
20%
Family finances / job insecurity
18%
Too inconvenient to travel whilst quarantine rules are in place
18%
Uncertainty around when travel restrictions will be lifted
14%
I don't want to travel in a confined space (e.g. Aircraft)
12%
Concerns over terrorism, safety and/or local conditions
12%
Difficult to find the holiday I want
6%
Family circumstances (moving house, pregnant etc)
4%
Saving to go abroad on holiday another year
4%

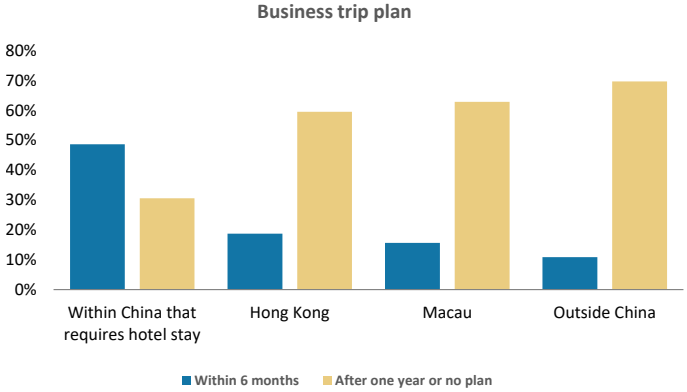
Source: AlphaWise, Morgan Stanley Research

Non-domestic travel not recovering within the next 12 months

About 30% respondents reported no plans for domestic travel in a year, for both business and leisure. In terms of overseas travel, 60-70% responded with no intention of a business trip within a year, while 70-80% responded with no intention of a leisure trip within a year.

Exhibit 12:

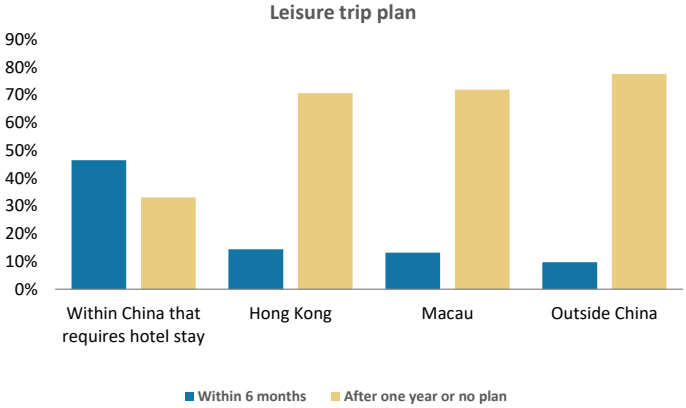
Business trip plans: domestic and overseas



Source: AlphaWise, Morgan Stanley Research

Exhibit 13:

Leisure trip plans: domestic and overseas



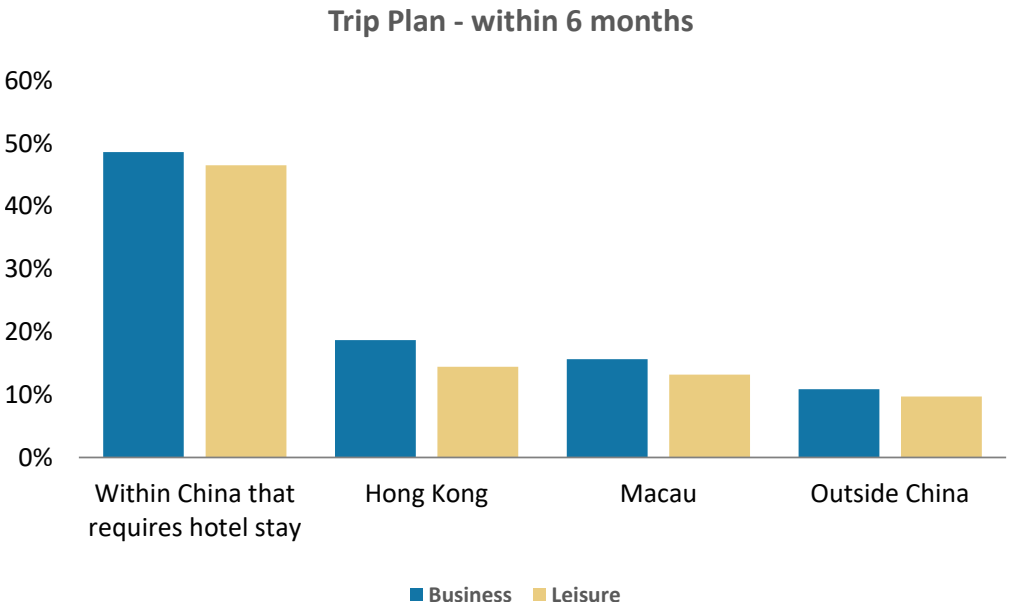
Source: AlphaWise, Morgan Stanley Research

Slightly higher intention for business travel vs. leisure travel

By all destinations, intention for travel within six months is 1-5ppt higher for business than for leisure.

Exhibit 14:

Business vs leisure trip plans within 6 months



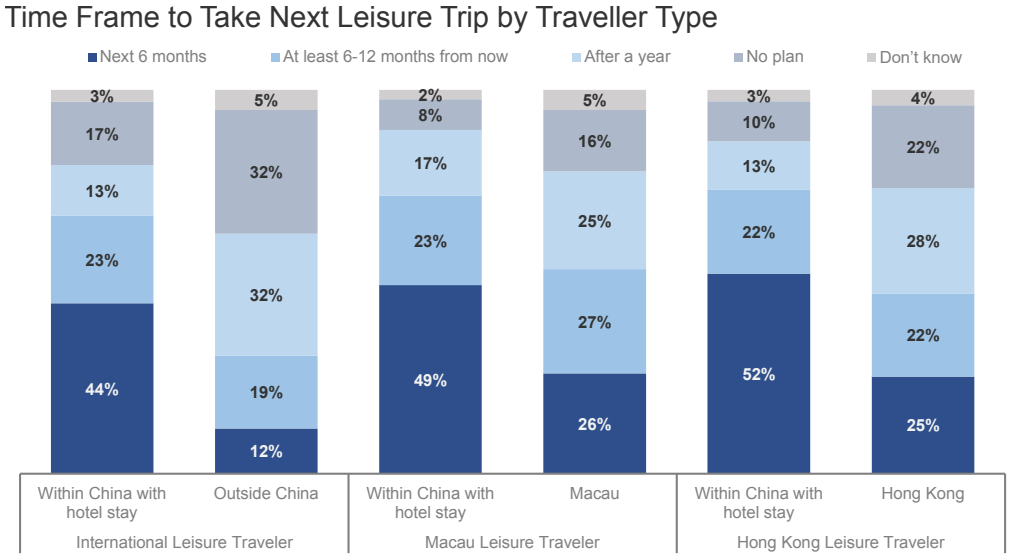
Source: AlphaWise, Morgan Stanley Research

The new normal is to travel within China rather than outside China

Travellers who used to regularly visit HK, Macau or outside mainland China, said they will more likely travel within mainland China than anywhere else in the next six months.

Exhibit 15:

Time frame for the next leisure trip: within vs outside mainland China



Source: AlphaWise, Morgan Stanley Research

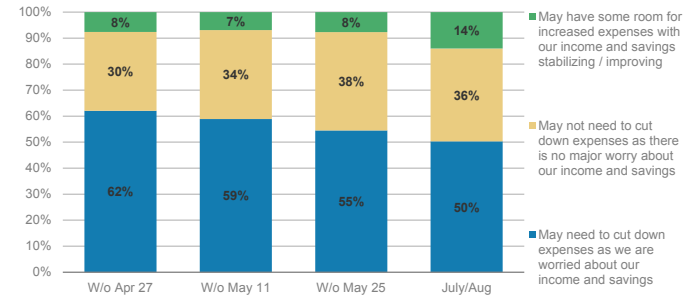
Likely lower budgets for shopping

Intention to spend less than Rmb10,000 on shopping goes up to 67% from 43% from our 2017 survey; on average, shopping budget per traveler will likely be down by ~30% from the 2017 level to Rmb9,300. Willingness to spend on shopping drops, with 24% rating shopping spend as their biggest travel expense on their next trip, down from 40% in 2017.

Exhibit 16:

50% think they may need to cut household expenses next month

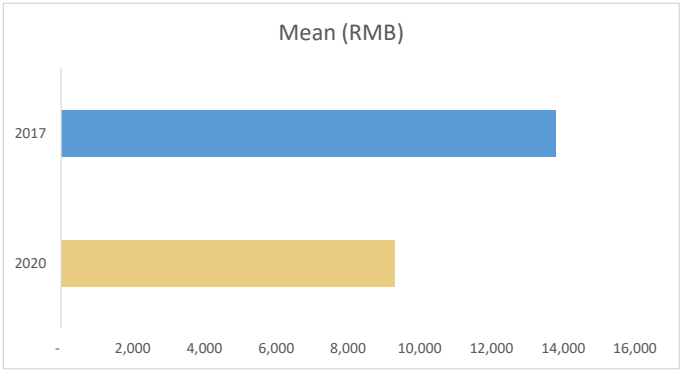
Household Financial Outlook for Next Month by Total



Source: AlphaWise, Morgan Stanley Research

Exhibit 17:

Lower overseas shopping budget in 2020 vs 2017



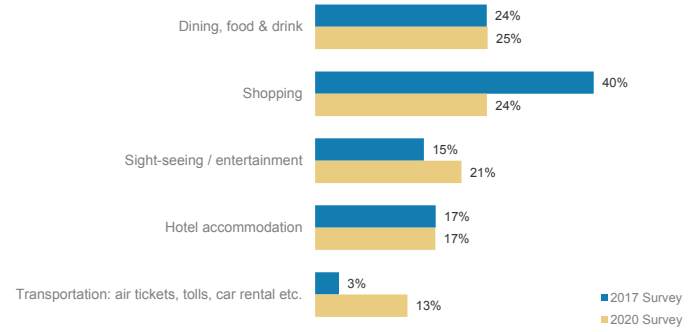
Source: AlphaWise, Morgan Stanley Research

Note: 2017 data based on a separate survey conducted in 2017

Exhibit 18:

Lower budget on shopping, higher budget on transport and entertainment

Top Categories to Spend Most on Next Trip by Total: 2020 vs. 2017 Survey



Source: AlphaWise, Morgan Stanley Research

Note: 2017 data based on a separate survey conducted in 2017

Exhibit 19:

Duty-free/airport shops remain top shopping destination for the next trip

Likely Shopping Destination for Next Trip by Total

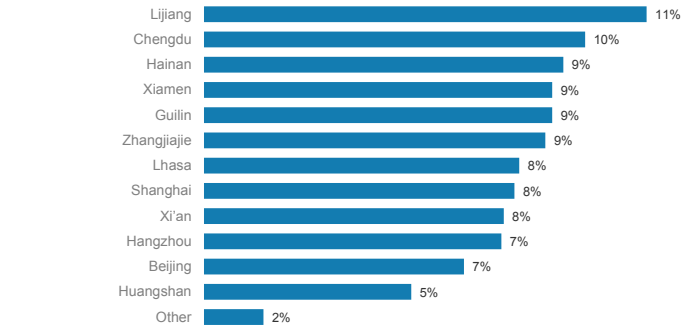
Source: AlphaWise, Morgan Stanley Research

Some evidence hinting at positive outlook for Hainan Meilan International Airport's (HMIA) duty free operations

Among domestic travel destinations, Hainan ranks third after Lijiang and Chengdu. In terms of shopping destinations, duty free shops remain the top choice among travellers. In addition, watches & jewelry and leather goods are the two product categories that travelers are significantly more likely to purchase versus the previous survey in 2017. Evidence points to a positive outlook in HMIA's duty free operations driven by both traveler growth and per traveler spending.

Exhibit 20:

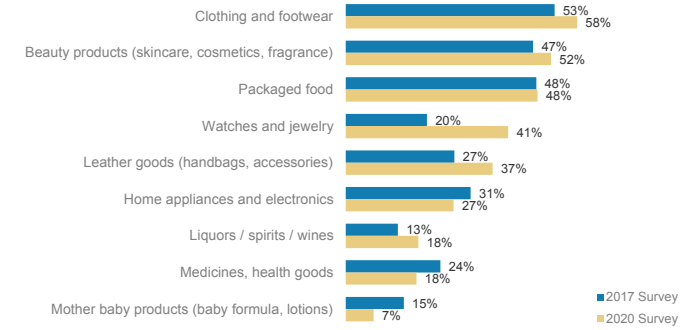
Top travel destinations within China



Source: AlphaWise, Morgan Stanley Research

Exhibit 21:

Product categories likely to be purchased on next trip


Product Categories Likely to be Purchased on Next Trip by Total: 2020 vs. 2017 Survey
Clothing and footwear 53% 58%
Beauty products (skincare, cosmetics, fragrance) 47% 52%
Packaged food 48% 48%
Watches and jewelry 20% 41%
Leather goods (handbags, accessories) 27% 37%
Home appliances and electronics 31% 27%
Liquors / spirits / wines 13% 18%
Medicines, health goods 24% 18%
Mother baby products (baby formula, lotions) 15% 7%
2017 Survey
2020 Survey

Source: AlphaWise, Morgan Stanley Research

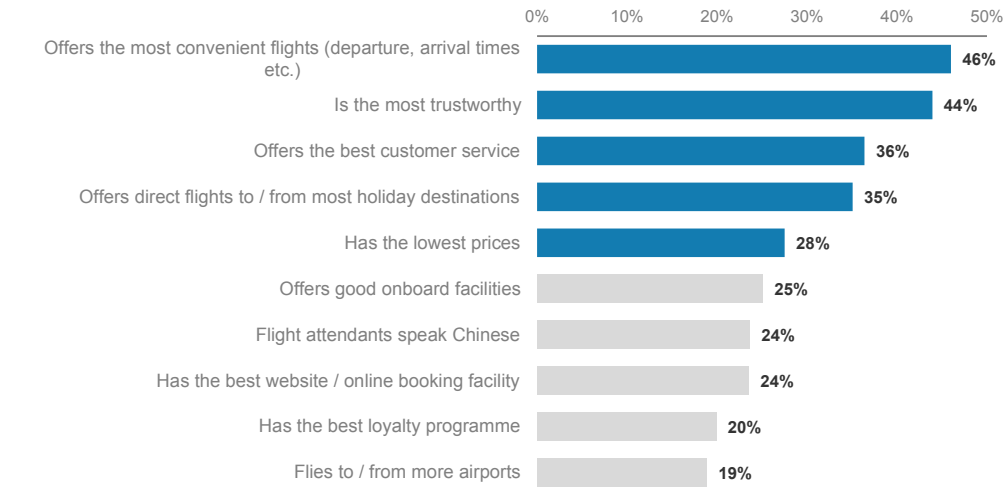
Note: 2017 data based on a separate survey conducted in 2017

Airlines preference

Convenience (slot), trustworthiness and service quality are ranked top 3 reasons for choosing an airline, followed by direct flight and having the lowest price.

Exhibit 22:

Reasons for choosing an airline


Top Three Aspects to Consider While Choosing an Airline by Total
0%
10%
20%
30%
40%
50%
Offers the most convenient flights (departure, arrival times etc.) 46%
Is the most trustworthy 44%
Offers the best customer service 36%
Offers direct flights to / from most holiday destinations 35%
Has the lowest prices 28%
Offers good onboard facilities 25%
Flight attendants speak Chinese 24%
Has the best website / online booking facility 24%
Has the best loyalty programme 20%
Flies to / from more airports 19%

Source: AlphaWise, Morgan Stanley Research

Airlines: Not Close to the End of the Tunnel

Market view: We have seen the worst in airlines' fundamentals. Bad news are all in the price.

Our view: Although we have seen passenger volume recovery on China's domestic routes, we think low ticket prices will sustain as long as international travel remains sluggish. Airlines' depressed earnings will erode their book and lead to potential further downsides.

Where we could be wrong: Global travel resuming faster than expected; new policy to restrict China domestic market supply; industry consolidation; massive capital injection by the government.

Why we used to be bullish

Higher load factors thanks to supply constraints

Previously, we had argued in our sector note published July 2019 that Chinese airlines will benefit from higher pricing power due to improving passenger load factors in the medium- to long-term. This thesis was backed by favorable CAAC policies, as recapped below:

Airport slot capacity limits: CAAC has exerted stringent control on growth of landing/take-off slots at China's major airports, as an effort to improve flight punctuality. Starting from the winter/spring flight season of 2017, major airports' slot growth are limited to only 3% YoY. China's total airport slot growth has slowed down from the 8.9% YoY in 2019 summer/autumn season to only 5.9% YoY in 2019 winter/spring season. Such slot growth is low compared with China's air passenger CAGR of 11% in the past 10 years, implying a supply tightness. A crucial reason behind CAAC's tight slot capacity control has been the airspace bottleneck. In China, only 20-25% of the airspace is for civilian use (the rest reserved for the military), vs 80% in the US.

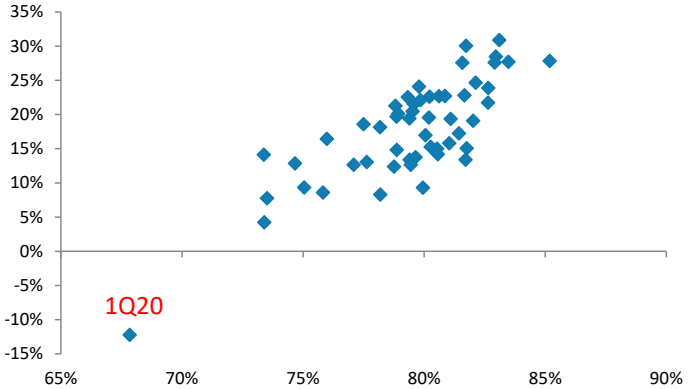
Market-adjusted pricing mechanism on domestic routes: CAAC's policy allows a maximum 10% hike in the full-price for economy class on certain domestic routes operated by no less than 5 airlines, in each flight season (i.e. twice a year). The policy allows price hikes for up to 15% of routes that had adopted market-adjusted prices in the previous flight season.

Airlines' margins positively correlated with load factors

We believe that airlines' margins are positively correlated with load factors. This is because a higher asset utilization should lead to higher pricing power and higher passenger yield. In 2018-2019, passenger load factors have improved during peak season, for China's airlines industry.

Exhibit 23:

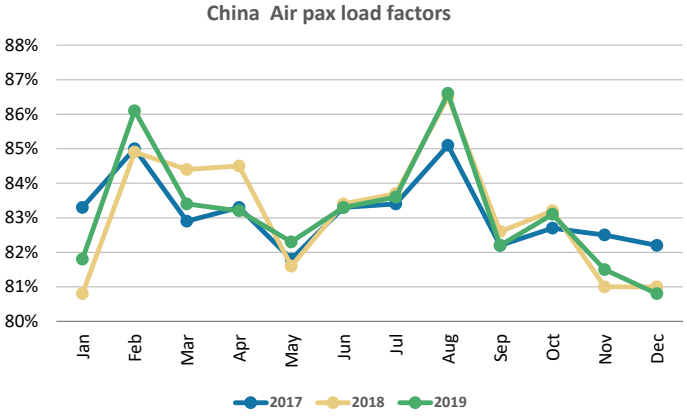
Air China: pax load factors and GPM (quarterly, 3Q06-1Q20)



Source: Company data. Note: some 4Q outliers removed due to potential one-off adjustments by the listco.

Exhibit 24:

Pax load factors improved in 2018-2019 vs. 2017



Source: CEIC

What has been changed by COVID-19

We believe the supply side for Chinese airlines will no longer be tight, due mainly to a slower than expected recovery in non-domestic travel. We expect a continued oversupply in terms of aeroplanes as well as airport capacity.

Structural changes – not favorable to the demand side

We surveyed 2,667 Chinese residents living in Tier 1-3 cities during July to August 2020 using online interviews, with 1989 being travelers. The margin of error for findings on the total sample is ±1.5% at 90% confidence level and higher for subgroups.

We see several potential new normals which may impact the demand side of Chinese airlines:

1. Travel sentiment has been decreasing, especially on non-domestic routes, due mainly to concerns resulting from COVID-19.
2. High probability to travel within China versus outbound – over 60% of respondents are not considering outbound travel within one year, versus ~30% for a domestic trip;
3. A lower budget due mainly to expense cuts.

Please refer to **AlphaWise Survey – The New Normal for Travel** for more details.

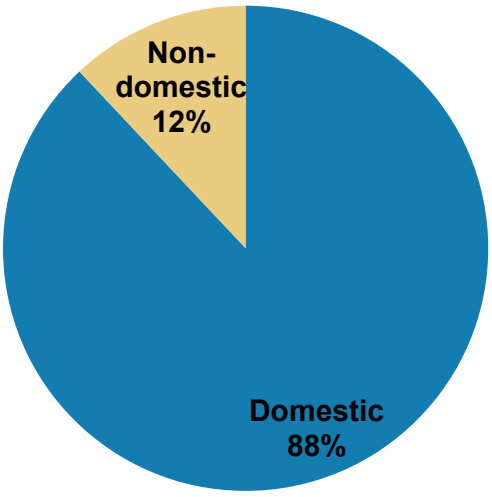
Supply may remain at a glut level

We estimate a 25% to 30% excess supply for Chinese airlines, assuming domestic demand recovers to 2019's level and non-domestic traffic stays low. We see two factors which could impact the supply side for airlines: aeroplanes and airport slots.

In 2019, non-domestic ASK accounts for 27% of total ASK among Chinese airlines (number of available seats of non-domestic routes accounts for 12%). On the airport-side, in 2019, regional and international landing slots accounted for 22% of total slots in Chinese airports.

Exhibit 25:

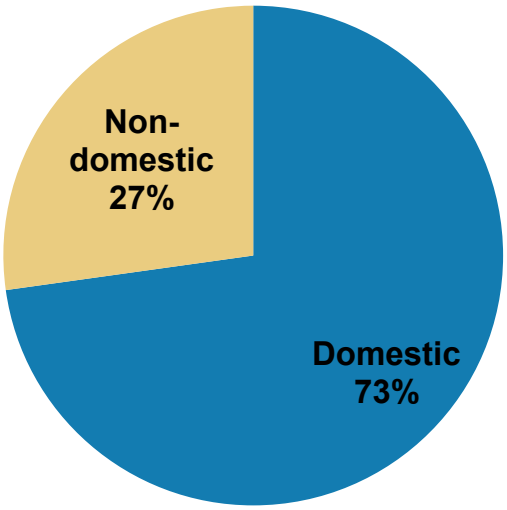
Chinese airlines seat breakdown: domestic vs. non-domestic (2019)



Source: OAG

Exhibit 26:

Chinese airlines RPK breakdown: domestic vs. non-domestic (2019)



Source: CEIC

Airlines are shifting international slots to domestic

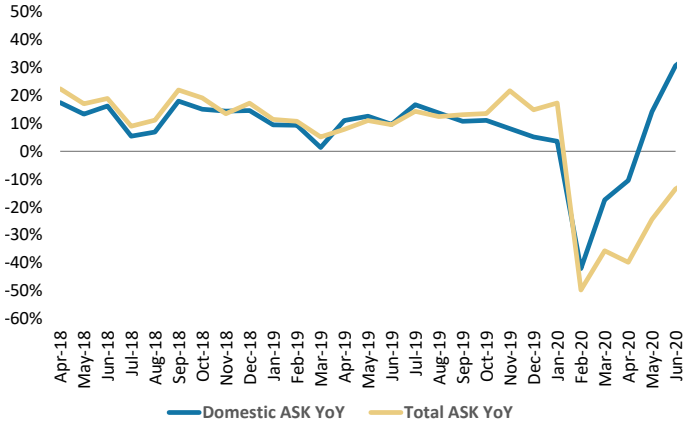
According to Spring Airlines, it can now shift international slots back to China's domestic market, if the plan is approved by corresponding airports and regional aviation administration bureaus.

CAAC also mentioned that it encourages airlines to replace non-domestic slots with domestic ones in the winter/spring flight season slot allocation guidelines.

Spring has switched some capacity from non-domestic routes to domestic routes, according to company management during its 1Q20 conference call. Indeed, Spring's domestic ASK increased each month after the trough in February, and is up 34% YoY in July 2020 (in FY2019 domestic ASK rose by 10% YoY). We expect more airlines to follow suit, if their domestic traffic could recover to beyond last year's level.

Exhibit 27:

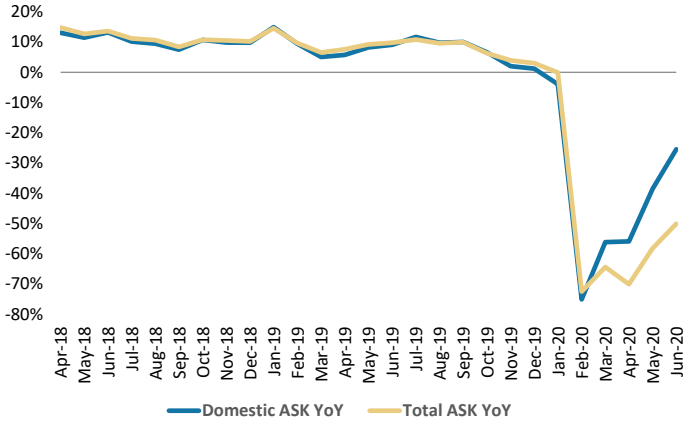
Spring Airlines: domestic vs total ASK YoY



Source: Company data

Exhibit 28:

Chinese airlines in total: domestic vs total ASK YoY



Source: Company data

A turnaround in earnings may take more time

Price-based competition likely to continue

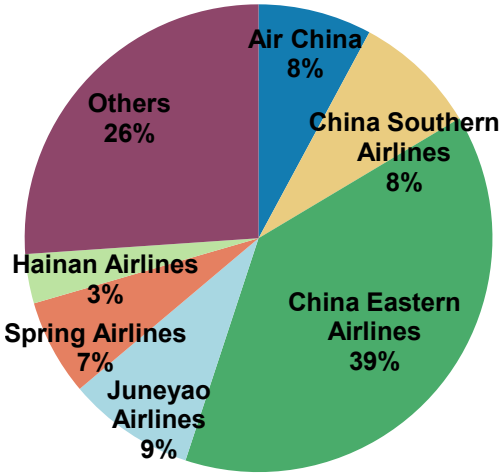
We think price-based competition will likely continue in China's airlines industry, due mainly to:

- **Airline services are perfect substitutes:** Chinese airline services are homogeneous, making pricing one of the major factors for airlines to differentiate themselves.
- **Minimal marginal cost:** Once a flight is in the air, all costs are fixed, implying a minimal marginal cost for taking one extra passenger. Thus, airlines are encouraged to offer low prices to improve load factors.
- **Low market concentration:** The supply concentration for Chinese airlines is not high enough; Chinese airlines do not have the capability to control the supply side for the market.

In China's top 4 airports, the Big 3 airlines combined, control only 55%-72% of the total seat capacity, which we think is not high enough to ensure a strong control from the supply side. We think it is unlikely that major airlines can coordinate and cut supply in order to protect margins.

Exhibit 29:

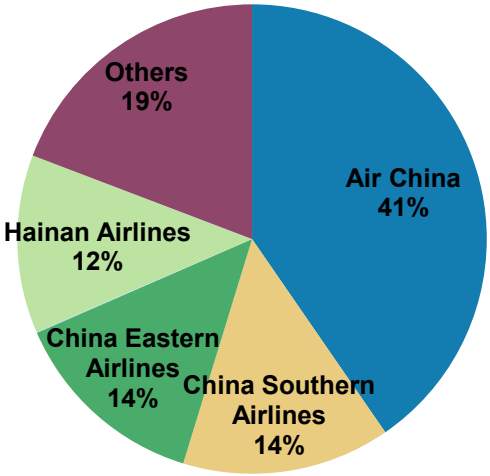
Shanghai Pudong: 2019 seat capacity by airlines



Source: OAG

Exhibit 30:

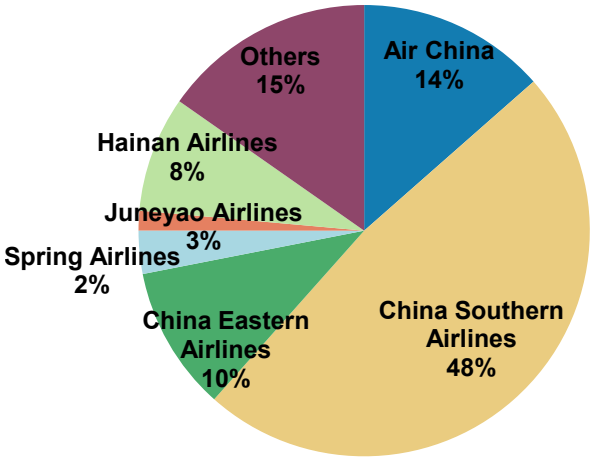
Beijing Capital: 2019 seat capacity by airlines



Source: OAG

Exhibit 31:

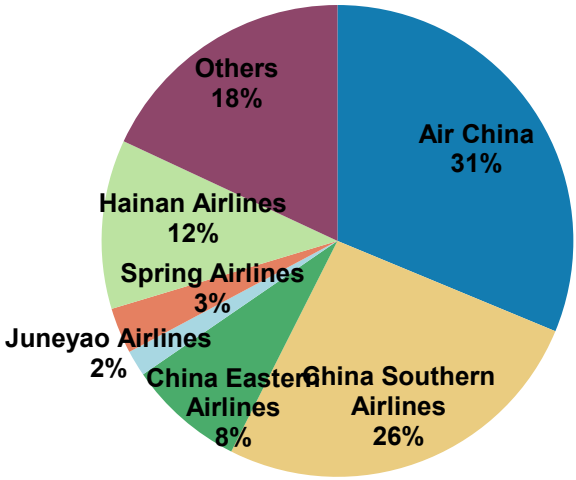
Guangzhou Baiyun: 2019 seat capacity by airlines



Source: OAG

Exhibit 32:

Shenzhen: 2019 seat capacity by airlines



Source: OAG

Case study: The supply side control for Container Shipping

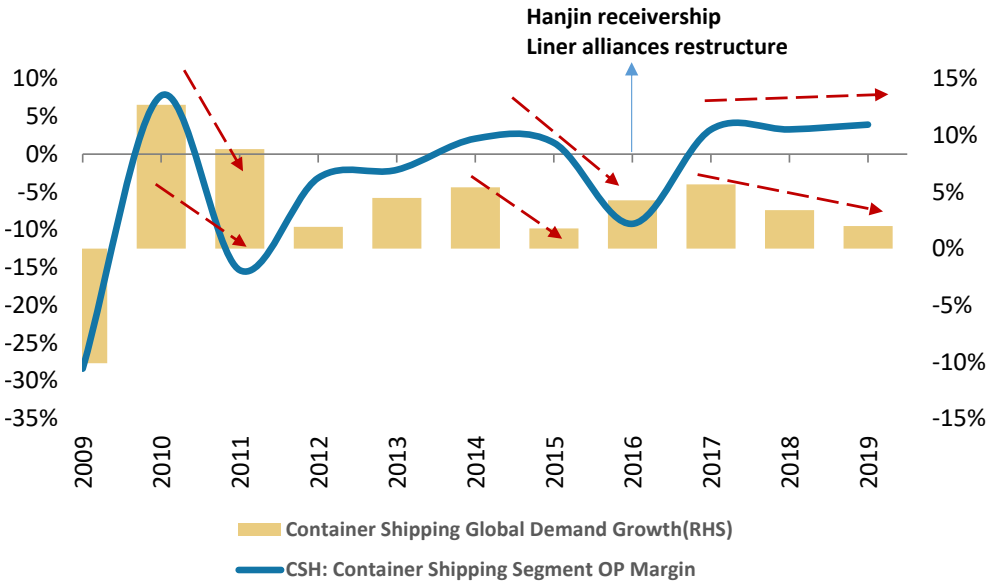
Container shipping is an industry with similar economic characteristics to airlines, in terms of:

- It operates with fixed schedules – indicating a high percentage of fixed costs and a minimal marginal cost for one extra container box loaded (passenger carried for airlines).
- Services from different operators are highly substitutable.
- A strong economy of scale for major operators given high sales and marketing costs.
- Slots/seats are sold to a large number of customers with flexible pricing schemes.

Container shipping used to be a highly cyclical industry which had made huge losses during cyclical downturns. However, the industry has successfully improved its supply side by consolidation and alliances. After Hanjin's receivership in 2016, the top alliances have been restructured, and gained better control over the supply side. Currently, the top 3 alliances (the OCEAN alliance, 2M, and THE) controls 99% capacity on Far East–Europe routes and 88% capacity in Far East–North America routes.

Exhibit 33:

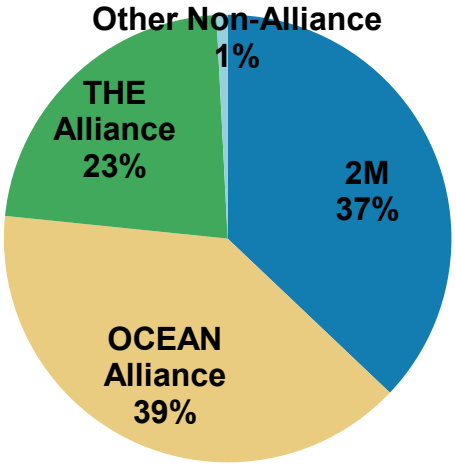
CSH's container shipping OP margin vs. global container shipping demand



Source: Company Data, Morgan Stanley Research

Exhibit 34:

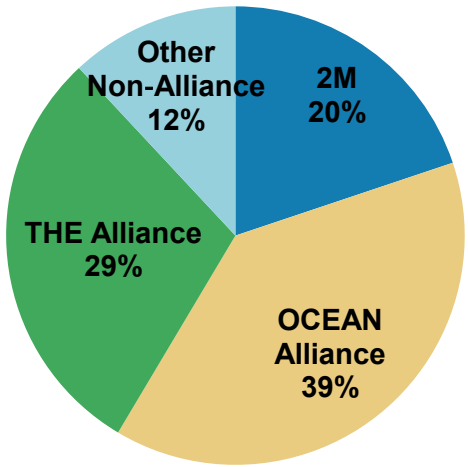
Container shipping: Far East–Europe capacity breakdown by alliance



Source: Alphaliner. Note: as of July 2020

Exhibit 35:

Container shipping: Far East–North America capacity breakdown by alliance

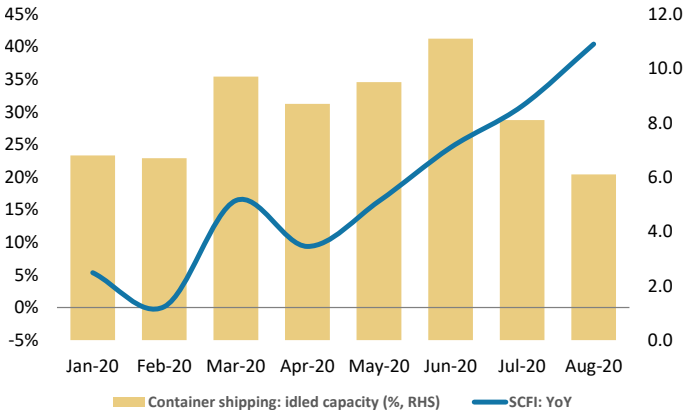


Source: . Alphaliner. Note: as of July 2020

Thanks to the strong supply side controls, the container shipping industry has successfully idled capacity during the demand hit in 1H20 led by COVID-19: 7M20 average Shanghai Containerized Freight Index increased by 14% YoY, amid a drop in China's exports in 1H20.

Exhibit 36:

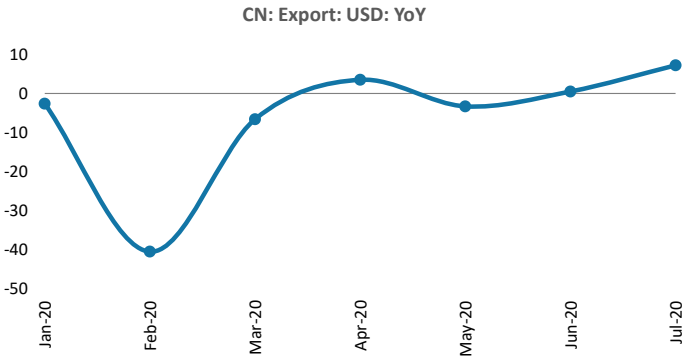
Liners aggressively idled capacity and protected shipping rates...



Source: Clarksons, Morgan Stanley Research

Exhibit 37:

Amid the demand hit from COVID-19



Source: CEIC

Consolidation for Chinese airlines is not easy

We think consolidation is not easy for Chinese airlines, due mainly to:

- The Big 3 airlines – Air China, China Eastern and China Southern – are state-owned, and backed by the government. Also they each dominate one region in China – Air China in North China, China Eastern in East China and China Southern in South China.
- In 2019, there were 62 airlines in China, versus 60 in 2018. 48 out of the 62 airlines are state owned, while only 14 are private owned. Some of the airlines are held by regional governments, making them difficult to merge with other airlines, in our view.

Airlines' sales packages are de facto price war

Chinese airlines have recently started marketing their sales packages, which we think could be initiating a price war. We think this may lead to depressed earnings for airlines in 4Q20, when the 3Q peak season ends.

Exhibit 38:

Chinese airlines: Sales packages offered

	Price (Rmb)	Launch date	Valid till	Limited seats for package users?	Refund	No show penalty	Sales vol	Major market
CEA	3322	18-Jun-20	31-Dec-20	No	Allowed with conditions	Yes	100000	Nationwide
CEA	3456	5-Aug-20	30 June 2021 (2021 Chinese New Year period excluded)	No	Allowed with conditions		Limited quantitiy	Nationwide
CSA	3699	28-Jul-20	6-Jan-21	Yes				Nationwide
Spring	2999/3499/3999	15-Jul-20	31-Dec-20	Yes		Yes		Nationwide
Juneyao	888	10-Jul-20	31-Dec-20	Yes	Allowed with conditions			Jiangsu, Zhejiang, Shanghai
Lucky Air	single person pass: 1588-8588 / group pass: 12588-128888	13-Jul-20	Monthly pass, Quarter pass, Half-year pass, Year Pass	Yes		Yes		Yunnan, Guizhou
Sichuan Airlines	399/999	22-Jul-20	31 Dec 2020 (2020 National Holiday excluded)	No			Limited quantitiy	Sichuan, Chongqing
China Express Air	2999	23-Jun-20	24 Oct 2020 (2020 National Holiday excluded)	No	No refund	Yes	1000	Southwest China , Northwest China
HNA	2999 (2699 for the first 2000 buyers)	6-Jul-20	31-Dec-20	Yes	Allowed with conditions	Yes	10000	Hainan

Source: Company Data, Morgan Stanley Research

Downgrade Big 3 A and H shares

We further cut our 2020-2022 earnings forecasts

We cut our EPS forecasts for Chinese airlines by an average 122% in 2020, and an average 122% in 2021, due mainly to:

- Lower traffic assumptions, especially on non-domestic routes
- Lower domestic yields

Our forecasts imply a 9.4ppt lower 2021 ROE, and 12ppt lower 2022 ROE, versus consensus.

Exhibit 39:

Chinese airlines: Traffic and yield assumptions

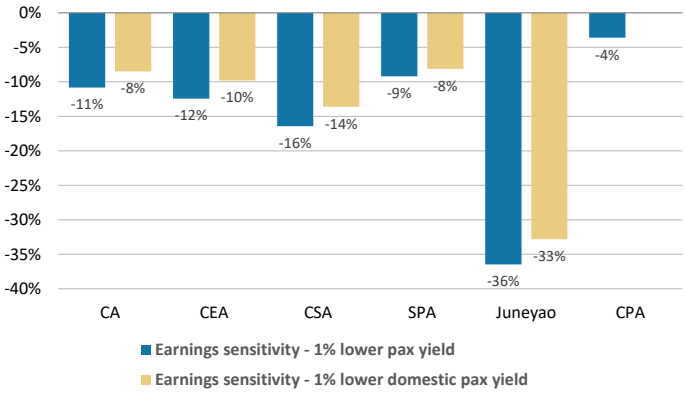
	RPK (mn)					Pax yield (Rmb/RPK)				
	2019	2020e	2021e	2022e	CAGR 2019-2022E	2019	2020e	2021e	2022e	2022E VS. 2019
Air China	233,176	116,943	196,827	253,743	3%	0.53	0.47	0.52	0.51	-4%
YoY %		*-50%*	*68%*	*29%*			*-11%*	*10%*	*-1%*	
China Eastern Airlines	221,779	118,231	201,635	255,294	5%	0.50	0.43	0.47	0.48	-4%
YoY %		*-47%*	*71%*	*27%*			*-14%*	*11%*	*1%*	
China Southern Airlines	284,921	158,985	258,778	321,820	4%	0.49	0.46	0.49	0.47	-2%
YoY %		*-44%*	*63%*	*24%*			*-6%*	*6%*	*-2%*	
Spring Airlines	39,691	28,765	37,655	49,370	8%	0.36	0.32	0.35	0.36	0%
YoY %		*-28%*	*31%*	*31%*			*-12%*	*10%*	*3%*	
Juneyao Airlines	34,770	24,232	35,762	42,769	7%	0.47	0.41	0.45	0.46	-2%
YoY %		*-30%*	*48%*	*20%*			*-12%*	*11%*	*1%*	
Cathay Pacific (yield in HKD)	134,397	27,547	61,216	117,536	-4%	0.55	0.60	0.63	0.58	5%
YoY %		*-80%*	*122%*	*92%*			*9%*	*5%*	*-7%*	

Source: Company Data, Morgan Stanley Research estimates

In 2021, every 1% lower overall yield would lead to 4% to 36% lower earnings on our forecasts, or 0.5ppt to 1.4ppt lower return on 2019 equity.

Exhibit 40:

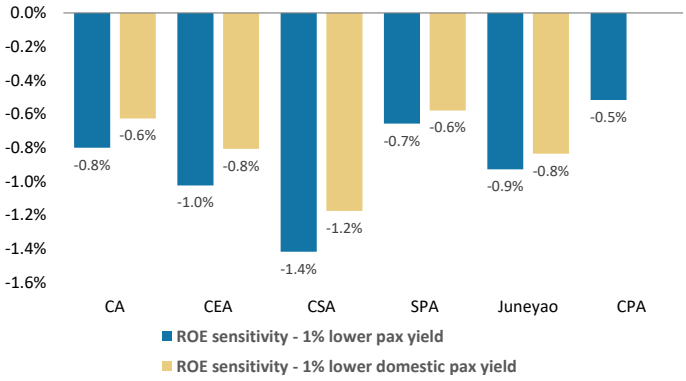
Sensitivity: 2021e earnings



Source: Morgan Stanley Research estimates

Exhibit 41:

Sensitivity: 2021e ROE changes in ppt



Source: Morgan Stanley Research estimates; Note: Calculation based on 2019 BPS

Sustained book erosion due to losses

Market think airline valuations have factored in a pessimistic demand outlook already, given their valuations are already at or below historical lows. However, we argue that continued loss making should lead to further book erosion over time, which means the current P/B valuation multiple for airlines are not cheap enough.

Based on our calculation from airlines' 1Q20 results, the maximum monthly loss making for the Big 3 airlines is at Rmb3-4bn. This implies 4-6% of book value reduction every month. Looking ahead, the sharp decline in domestic ticket prices and sluggish international air traffic recovery are likely to put airlines companies under sustainable loss-making situations in 2Q-4Q20.

Therefore, although current valuations for airlines looks to be low, multiples will increase as book value per share drops. We still see downside risks in share prices given the potentially further book value erosion from big-ticket losses.

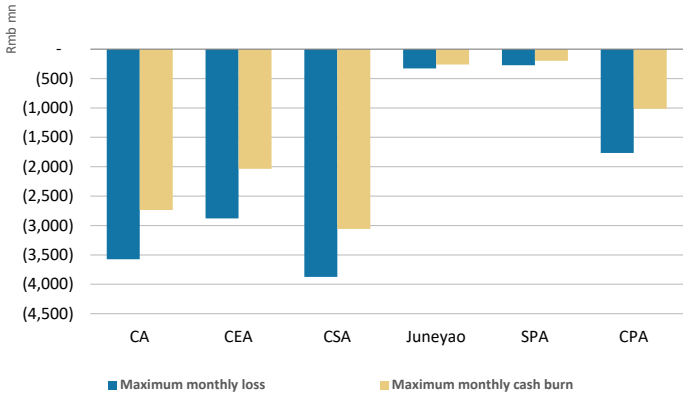
Operating cash flow to stay under pressure

Chinese airlines face sizable cash burn given ticket price weakness and inelastic costs including salary, lease expenses, rental, etc. After excluding non-cash depreciation and amortization, we estimate that Air China/ CEA/ CSA/ Juneyao will have maximum monthly negative operating cash flow of Rmb2.7bn/ Rmb2.0bn/ Rmb3.0bn/ Rmb260mn.

However, our estimation of monthly cash burn could be affected by working capital changes of airlines, especially if there is massive ticket refund, or sharp increase or decrease in forward bookings. For example, if a second-wave of the COVID-19 pandemic burst in on China and the government re-initiated travel restrictions, airlines may suffer from sizable cash outflow due to refunds.

Exhibit 42:

Maximum monthly losses and cash burn for airlines



Source: Company data, Morgan Stanley Research

Downgrades to CEA and CSA

We resume coverage on Air China H and A shares with EW and UW, respectively. Downgrade CSA-H to EW, and CSA-A to UW. Downgrade both CEA A and H to UW.

We UW all three A shares, due mainly to our views that A-H share premium may narrow with increased Hong Kong - Shanghai Stock Connection. We like CEA the least in the Big 3, as we see higher downside risks to its earnings as it has offered more aggressive promotions versus the other two.

What would make us turn positive

Stronger than expected travel demand

Stronger than expected air traffic demand could occur if the economic growth exceeds our expectation, or if travel demand outgrows the macro economy as people switch from overseas travel to domestic travel.

Further policies on supply restrictions announced by CAAC

One of the key downside risks we worry about is that airlines may use their aircraft and airport slots for international routes to operate domestic flights, resulting in oversupply and low ticket prices. If CAAC announced any policy to cap airports' domestic slots, airlines will benefit from controlled supply growth.

Industry consolidation

Given sizable losses in the airlines industry, there might be mergers or acquisitions among airlines. This could reduce competition and support ticket prices. On 29 February, 2020, the Hainan provincial government established a working group to facilitate the restructuring of HNA Group, the parent of Hainan Airlines. We think that if Hainan Airlines is taken over by any one of the major airlines as part of the restructuring, it would be a positive catalyst for listed airlines, as Hainan Airlines had ~12% of market share in 2019.

Capital injection by the government

Capital injection by the government could be a positive catalyst for airline share prices. Historically, airlines conducted share placements to parent companies and received fund injections during aviation sector downturns. For example, after suffering from severe losses amid the global financial crisis, CEA and CSA announced Rmb7bn and Rmb3bn placements to their respective parentcos in December 2008. In addition, CEA conducted another Rmb6.4bn share placement to 10 entities (including its parentco) in July 2009, while both Air China and CSA did similar placements in March 2010 and raised Rmb5.6bn and Rmb10bn, respectively. Airline share prices rallied after these transactions were announced.

Airports: Short-term Headwinds and Changes to the Long-term Story

Market view: Market consensus is unclear about the length of international flight restrictions imposed by CAAC. Airports should be able to receive ~50% of the guaranteed minimum duty free rent in 2020.

Our view: Investors may have been too optimistic about the timing of international flights recovery. We also expect airport duty free revenue in 2020 may be based on the revenue sharing from actual duty free sales revenue, which could be only 15-20% of the guaranteed minimum rent. Therefore, consensus earnings face downward revision risks.

What could make us wrong: Global air travel resumes faster than expected; airports successfully get higher-than-expected amount of duty free revenue.

Short-term: Earnings headwinds due to international flight restrictions

Passenger traffic will continue to be dragged down by international routes

The CAAC has issued strict policy controls on international flights since March 29, 2020, in order to help control the COVID-19 pandemic. According to the policy, each Chinese airline can only operate one flight to one other country per week, while each foreign airline can only operate one flight per week between its domicile country and China. This has resulted in nearly-zero international traffic at Chinese airports, while domestic air traffic in China is already recovering to >70% of pre-COVID level.

Looking forward, we believe Chinese government restrictions on international flights will be sustained while the COVID-19 pandemic continues in foreign countries. Broad-scale international flight resumptions may not happen in the next 9-12 months, until an effective vaccine is developed or the the COVID-19 pandemic is well contained globally. We feel that current market consensus is ambiguous about the timing of international air travel recovery. Yet a broad-scale recovery until 2H21 would be worse than most investors' expectation.

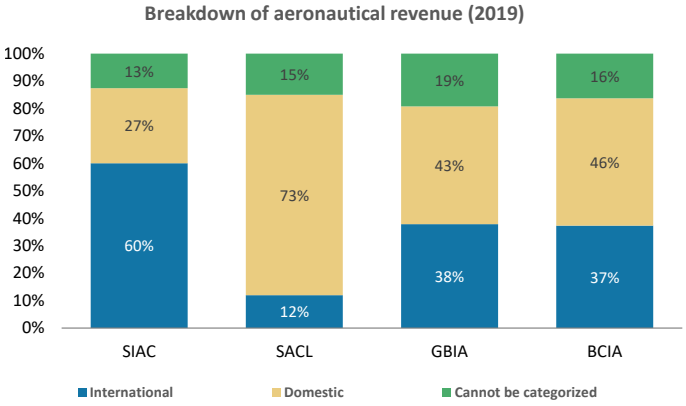
Airport revenues are highly dependent on international traffic

Chinese airport revenues are highly dependent on international flights and passenger traffic, because: (1) aeronautical charges on international routes are 2-3 times that of the charges on domestic routes; and (2) duty free revenue (only from international passengers) contributed an important portion of overall revenue for airports (45%, 35%, 10% of revenue for SIAC, BCIA and GBIA, respectively, in 2019). In particular, we highlight that duty free concession revenue growth has been the major revenue growth driver for SIAC and BCIA during the past five years.

Therefore, given the likely >80% YoY decline of international traffic in full-year 2020, we expect SIAC, BCIA, GBIA and SACL to see 57%, 66%, 22% and 20% YoY revenue decline, respectively, in 2020. Given fixed costs (labor costs, rental, depreciation, etc) represent roughly 70% of overall operating costs for airports, the big-ticket revenue decline will result in significant negative operating leverage. SACL and BCIA have already alerted to being loss making during 1H20, while we expect SIAC and GBIA to also make some losses in 2Q20. Looking ahead SACL and HMIA might be the only two profitable airports in 3Q19, given their heavy exposure to domestic passenger traffic.

Exhibit 43:

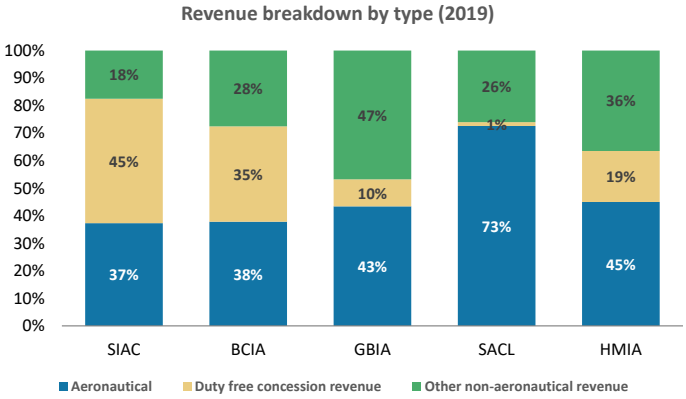
Aeronautical revenue breakdown for four major airports in 2019



Source: Company data, Morgan Stanley Research

Exhibit 44:

Revenue breakdown of Chinese airports (2019)



Source: Company data, Morgan Stanley Research

Exhibit 45:

Duty free has been the main growth driver (SIAC)

Source: Company data

Exhibit 46:

Duty free has been the main growth driver (BCIA)

Source: Company data

Uncertainty remains in duty free concession rents for 2020

Given the significant decline of international passenger numbers and consequent interruption in operations at airport duty free stores, CTGDF is unlikely to pay the full amount of guaranteed minimum duty free rent to airports as per contracted. According to airport managements, CTGDF has stopped paying rent since February 2020, and we have noticed that CTGDF has booked the guaranteed amount of duty free rent as expenses at the same time into payables, reflecting a contingent accounting treatment. In addition, from the 1H20 profit warning by BCIA and SIAC's 1Q20 results, we think airports also took a conservative accounting approach and did not book the guaranteed duty free rent into revenue.

CTGDF and airports have both guided that they will negotiate about the full year duty free rent payment at the end of 2020, when they are able to have a clearer picture for the full-year international passenger volume and airport duty free store sales revenue. The market expects that airports can get ~50% of the contracted guaranteed rent. However, we think it is difficult for airports to justify such a claim, because the airport duty free store sales collapse is caused by the global COVID-19 pandemic which is a *force majeure* situation rather than the responsibility of CTGDF.

In our view, the starting point of the negotiations will be the revenue sharing based on actual duty free sales revenue, which is 15-20% of the guaranteed amount and is our base case assumption. Potential upside to this scenario is that airports might be able ask for some compensation from CTGDF, given that CTGDF has made good profits from its Hainan and online duty free sales channels.

Long-term: No longer a proxy for China's duty free consumption growth

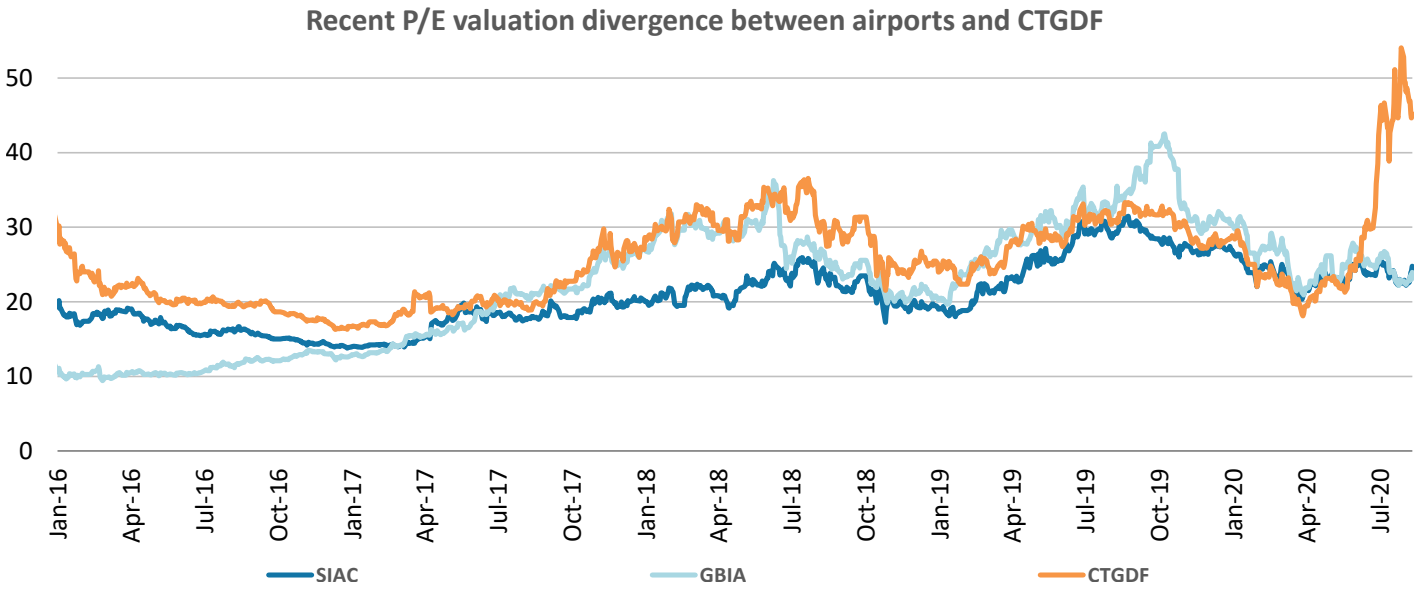
Earnings and valuations in the past were driven by duty free

Since 2017, the airport sector has become a proxy for China's duty free consumption growth. This was driven by: (1) fast growth of outbound travel and duty free consumption at airports; (2) airports are the only channel to purchase duty free goods for most residents in China; and (3) duty free revenue sharing ratios is increased from previous 20-30% to >40% in new concession contracts signed by airports (GBIA in May 2017, BCIA in Aug 2017, SIAC in Sep 2018).

As a result, airports enjoyed robust earnings growth and valuation re-rating since 2017. For SIAC, it recorded 21% earnings CAGR in 2016-19, with P/E multiples increased from high-teens before 2017 to ~25x on average in 2019. For GBIA, it enjoyed a more aggressive revaluation from ~10x P/E to 25-30x, given market expectation of its superior duty free revenue growth from a low base.

Exhibit 47:

Forward P/E of SIAC, GBIA and CTGDF



Source: Refinitiv, Morgan Stanley Research

Changes to the Long-term Story: Upcoming dilutions from emerging duty free shopping channels

The travel ban associated with the COVID-19 pandemic has triggered several new developments in the duty free sector in 1H20, including: 1) online duty-free goods purchase for travellers who have been to Hainan in the past 180 days; 2) Sunrise Beijing cross-border e-commerce; 3) Sunrise Shanghai online purchases and direct delivery; and 4) potential international shipping from Korean duty-free operators. In addition, we see two longer-term duty-free sector developments including pre-departure downtown duty free, and longer-term duty-free growth in Hainan associated with the Hainan Free Trade Zone blueprint. For more details, please read Mapping the New Normal: China's Duty-Free Evolution (8 Jun 2020) and Chinese Airports: Scenario Analysis on Duty-Free Evolution (8 Jun 2020).

We think Hainan's duty free development (both online and offline) could be the biggest threat to airports' duty-free operations. The impact could be two-fold:

- If customers have a good shopping experience in Hainan, both online and offline, they may have less need to make purchases at airport duty-free stores, which effectively reduces the per-passenger duty-free spending at airports.
- In the long term, if Hainan becomes a more popular travel destination, airports' outbound travelers may shift to Hainan, which would reduce airport duty-free stores' customer base.

In addition, we see medium level of threats from pre-departure downtown duty-free stores. Downtown duty free stores are currently only available to foreign passport holders, and are expected to be open to Chinese residents within this year. We expect some dilution to duty free consumption at airports, as some travelers may find it more convenient to visit the downtown duty free store before their trip. However, it is hard to quantify the impact, as there is still much uncertainty in shopping mall sizes and locations, product merchandise, pickup arrangements, etc.

Exhibit 48:

Summary of duty free evolutions and implications on airport duty free

	Duty free event	Impact on airport duty free	Level of threat to airport duty free and rationale
Recent duty free developments	CDF Hainan online	▪ Online duty free shopping after visiting Hainan may reduce customers' willingness to purchase at airport duty free ▪ This may also attract airport Daigou to move their business to Hainan	**High threat** Long term structural impact on airport duty free's customer base and purchase power
	Sunrise Beijing cross-border e-commerce	▪ International travellers may purchase less at airport duty free stores, as they can purchase online after they return home	**Low threat** Limited impact due to (1) controlled scale of eligibility, (2) fewer selection of products, and (3) cross-border e-commerce purchase quota
	Sunrise Shanghai direct shipment	▪ An alternative channel to purchase duty free goods ▪ This may also reduce Daigou at Shanghai airport	**Low threat** Limited impact due to (1) controlled scale of eligibility, (2) fewer selection of products, and (3) lower incentive for CITS given relatively low margin
	Korean duty-free international shipping	▪ An additional purchase channel for Daigou, which could reduce Daigou at airports	**Low threat** Limited impact due to uncertainties in execution of the internaitional shipping policy
Longer-term duty free developments	Pre-departure downtown duty free	▪ Airports' departure duty free stores face customer dilution to pre-departure downtown duty free	**Medium threat** Likely customer dilution to airport duty free stores but the scale of negative impact is uncertain due to (1) locations downtown duty free stores may not be convenient for many travellers, (2) uncertainties in pick-up arrangement.
	Hainan open up	▪ Good duty free shopping experience in Hainan may reduce customers' willingness to purchase at airport duty free ▪ This may also attract airport Daigou to move their business to Hainan ▪ Making Hainan a more attractive travel destination, which might be negative to airports' international air traffic	**High threat** Long term structural impact on airport duty free's customer base and purchase power

Source: Morgan Stanley Research

Potential de-rating over the medium term

Since June 2020, the new development in China's duty free industry has triggered strong market sentiment on CTGDF and Meilan Airport (HMIA), resulting in fast valuation divergence versus other airport stocks. If the emerging duty free shopping channels result in dilution of airport duty free revenue growth in the coming years, airports (in particular SIAC and GBIA) will shift from a high growth story to investments with stable growth, asset-heavy business model, high margin and rich cash flow. We thus are concerned about potential valuation de-rating for airport stocks, from previous 25-30x P/E to 20-25x range.

Downgrade Shanghai Airport to EW

We downgrade Shanghai Airport from OW to EW, considering headwinds in both the short-term (earnings pressure due to the COVID-19 pandemic) and long-term (duty free growth slowdown).

Heavy reliance to international traffic to bring earnings pressure in 2020 and 2021

SIAC's international passenger mix was 51% in 2019, the highest among Chinese airports. This is a plus for profitability in a normal year but more vulnerable amid international travel shutdown during the COVID-19 pandemic. We expect SIAC to experience a sharp 57% YoY revenue decline in full-year 2020, with loss making in 2Q20 and not far above break-even in 2H20. In 2021, under our current base case assumption that international passenger will largely normalize by 4Q21, SIAC's 2021 revenue and profit will be 21% and 29% lower than the respective levels in 2019, if we assume it cannot receive full amount of guaranteed duty free rent from CTGDF in 2021 before the pandemic ends.

Structural duty free story change in the long term

As analyzed in the above sections, we see limited upside in SIAC's per traveler duty free spending in the future, given dilutions from: (1) Hainan Island (online and offline) as an alternative duty free shopping channel; (2) pre-departure downtown duty free stores in Shanghai; and (3) relocation of resellers (daigou) from SIAC to Hainan. Despite the negative impact being hard to quantify, we do not think the majority of China's duty free market growth will happen at SIAC over the long-term, which makes SIAC a less direct proxy for the duty free sector. This might adversely impact investor valuations on SIAC, from a growth stock to an asset with stable but low growth, high margin and rich cash flow.

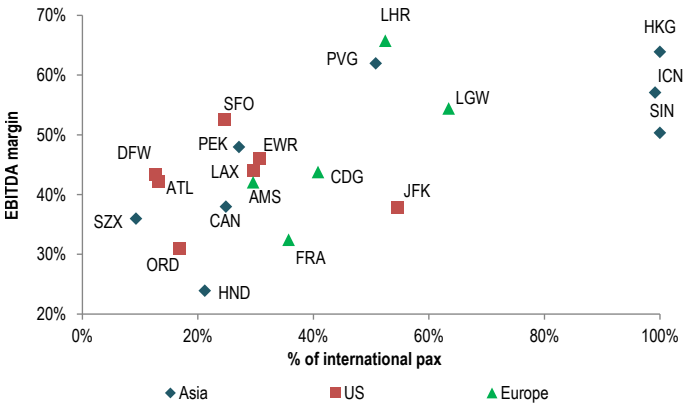
Why are we not UW SIAC?

We did not downgrade SIAC by one more notch to UW, because we still like SIAC's top-class asset quality which is depicted by its high EBITDA margin even amongst global airport peers. More specifically, there are two reasons that we do not UW SIAC among Chinese airport coverage:

- **Best guaranteed duty free contract among Chinese airports:** According to the duty free concession contract, SIAC's duty free minimum guaranteed rent will reach Rmb5.3bn and Rmb6.3bn in 2021e and 2022e (2019: Rmb5.2bn), respectively, and enjoys further 9% YoY growth during 2023 to 2025. That said, in a bear case that SIAC can only receive the guaranteed duty free rent, its net profit after 2022 will not fall below 2019's level and has a ~10% YoY growth with high certainty. In contrast, we estimated that the minimum guaranteed duty free rent in 2022e for BCIA and GBIA will be 68% and 10% lower, respectively, than their duty free revenue in 2019. This means potential downside earnings risk in the medium term if airport duty free consumption faces meaningful dilution from other duty free shopping channels.
- **Reasonable valuation:** Considering our analysis above that SIAC has ~10% YoY profit growth in the medium term with very high visibility, it's current 22x P/E for 2022e does not look expensive. We believe SIAC deserves a valuation premium versus the high-teens P/E multiple before 2017, given it's ROE has improved from the 12-13% before 2017 to 16-17% expected for 2022-2025.

Exhibit 49:

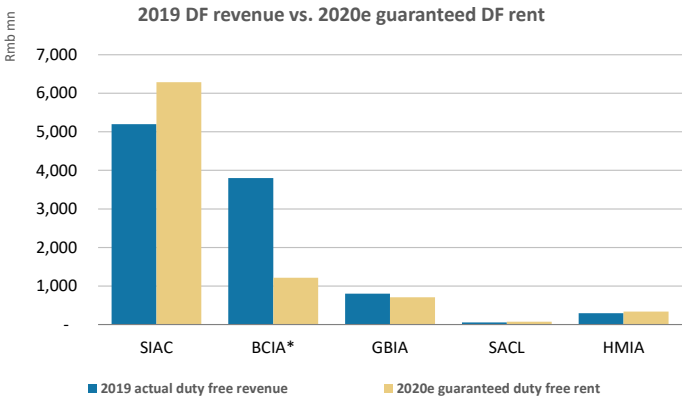
SIAC's (PVG) EBITDA margin is one of the highest in the world



Source: Company data, Morgan Stanley Research. Data are from airports' FY2018 and FY2019 annual report

Exhibit 50:

SIAC owns the best guaranteed duty free rent contract among Chinese airports



Source: Company data, Morgan Stanley Research. *Note: BCIA's duty free guaranteed rent is adjusted with YoY international pax growth in the previous year, according to contract. We are not sure whether such adjustment will be strictly followed given the volatility caused by COVID-19.

Order of Preference: Top pick HMIA

Among our Chinese airport coverage, HMIA remains our top pick. The two negative factors for other airports – (1) short-term international travel decline; and (2) long-term duty free growth slowdown – are contrarily two positive drivers for HMIA, as: (1) international flight restriction brings tourists re-shoring to Hainan; and (2) positive growth potential in Hainan duty free market. For details, please read Hainan Meilan International Airport: Marching on the growth track with eased dilution risk (31 Jul 2020).

Our AlphaWise Survey depicts a chain of evidence pointing to a positive outlook for HMIA's duty free operations, including: (1) higher intention to travel domestically; (2) Hainan is the third preferred destination; (3) duty free is the most preferred shopping destination for travelers; and (4) travelers currently show significantly higher interest in watches, jewelry and leather goods versus in 2017. We think this evidence leads to higher traffic growth and duty free spending at HMIA. Please refer to **AlphaWise Survey – The New Normal for Travel** for more details.

GBIA is our second-most preferred airport, given its relatively high traffic exposure to domestic traffic which will bring relatively fast earnings recovery. In addition, GBIA's current 24x P/E valuation is at discount to its 3-year average at 27x. SIAC's preference is after GBIA, considering short-term uncertainty in earnings due to its highest exposure to international traffic. For SACL, we think its 29x P/E (at premium to 3-year average of 27x) is stretched as it has already priced in SACL's potential earnings normalization in 4Q20 when domestic air travel in China resume to pre-COVID level. BCIA remains our least preferred airport, considering its worst earnings outlook in 2020 and 2021 due to COVID-19 and traffic transition to Daxing Airport.

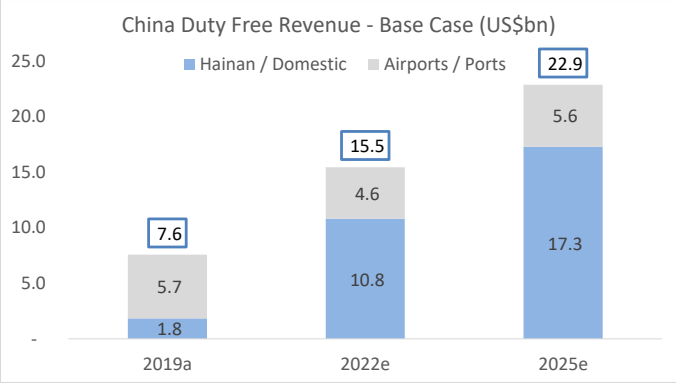
Implications for the China Duty Free Market

Our AlphaWise survey supports our OW investment thesis on CTG Duty Free (CTGDF), the proxy for China's duty free market with 90% market share. As highlight in our Asia Insight report Mapping the New Normal: China's Duty-Free Evolution (8 Jun 2020), China's duty free market is evolving from outbound travel reliance to domestic travel/ consumption focus. We highlight three drivers behind the evolutionary change of China duty free market – (A) Hainan free trade zone, (B) Online sales with home delivery, and (C) mainland downtown.

We expect China's duty free market size to triple from US$7.6bn (Rmb53bn) to US$23bn (Rmb164bn) in 2025e (**Exhibit 51**). Domestic channels' (incl. Hainan, online and downtown) contribution should increase from 24% in 2019 to >70% in 2025e (**Exhibit 52**).

Exhibit 51:

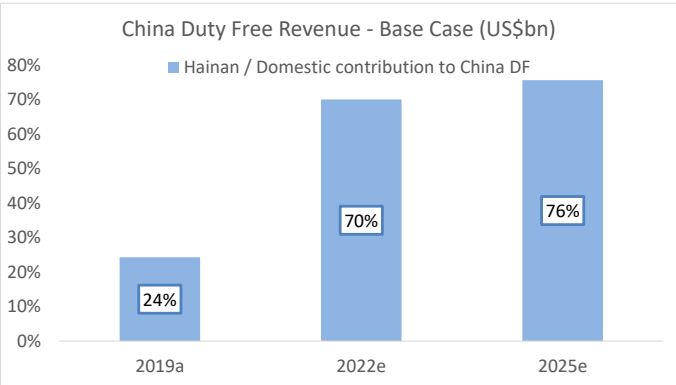
Chinese duty-free market size to triple from 2019 to 2025e



Source: Company data, Morgan Stanley Research (e) estimates

Exhibit 52:

Hainan/domestic contribution to reach 70-75% in 2022-25e



Source: Company data, Morgan Stanley Research (e) estimates

Travellers' travel preference changes suggested by our AlphaWise survey are supportive to these new initiatives:

- **More domestic travel with Hainan as the top travel destination** (**Exhibit 15** and **Exhibit 20**): This is positive to duty free sales in Hainan. CTGDF has a monopoly in the Hainan duty free market. Hainan duty free policy relaxation since 1st July 2020 is materially positive to attract demand. Hainan duty free sales revenue in July-20 grew +234%YoY and 46%MoM. The number of shoppers grew 43%YoY or 13%MoM and per capita spending grew 134%YoY or 29%MoM.
- **Shopping less during travel because online e-commerce can fulfil the demand**: CTGDF launched several online sales platforms in 1Q20. Among those, the Sunrise Shanghai platform provides home delivery of duty-free priced products to consumers who may not even have any travel record. CTGDF has settled all related import tariffs and VAT and sells the products at attractive prices. Apart from that, the company also recently launched Hainan duty free online channel on Taobao, which should drive sales growth further, we believe.
- **More luxury products to be purchased during travel** (**Exhibit 21**): This is positive to CTGDF as the products offered are luxury/ discretionary. In July-20, 28% of Hainan duty free revenue was contributed by high-value items of >Rmb8K. We estimate cosmetics, accessories and watches accounted for 50%, 14% and 12% of Hainan duty free revenue, respectively, in July-20.
- **Product pricing is a key factor; duty free stores as most preferred shopping places** (**Exhibit 19**): Bargain prices and one-stop shops should continue to attract consumers to duty free stores. CTGDF's Sanya duty free mall is the world's largest duty free store with 700K sq.ft. Such a large scale could accommodate a wide range of products as well as large consumer foot-traffic.

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Not-Rated/Hold	4	0%	1	0%	25%	3	0%
Underweight/Sell	554	17%	86	11%	16%	225	15%
Total	3,264		752			1479	

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INDUSTRY COVERAGE: Hong Kong/China Transportation & Infrastructure

COMPANY (TICKER)	RATING (AS OF)	PRICE* (08/17/2020)
Qianlei Fan, CFA		
Air China Limited (601111.SS)		Rmb7.30
Air China Limited (0753.HK)		HK$5.27
Beijing-Shanghai High-Speed Railway (601816.SS)	O (07/03/2020)	Rmb6.40
BOC Aviation (2588.HK)	E (11/27/2018)	HK$49.50
Cathay Pacific Airways (0293.HK)		HK$5.57
China Eastern Airlines (600115.SS)	E (01/11/2018)	Rmb4.92
China Eastern Airlines (0670.HK)	O (01/11/2018)	HK$2.99
China Merchants Energy Shipping Co. Ltd. (601872.SS)	O (03/10/2020)	Rmb6.57
China Merchants Port Holdings (0144.HK)	O (10/15/2019)	HK$9.25
China Southern Airlines (600029.SS)	E (07/22/2019)	Rmb5.80
China Southern Airlines (1055.HK)	O (07/22/2019)	HK$3.86
COSCO SHIPPING Energy Transportation (1138.HK)	O (03/10/2020)	HK$3.71
COSCO SHIPPING Energy Transportation (600026.SS)	E (03/10/2020)	Rmb7.78
COSCO Shipping Holdings Ltd (601919.SS)	E (10/15/2019)	Rmb5.42
COSCO Shipping Holdings Ltd (1919.HK)	O (10/15/2019)	HK$3.90
COSCO SHIPPING Ports Limited (1199.HK)	E (08/29/2018)	HK$4.36
Daqin Railway Co. Ltd. (601006.SS)	E (10/10/2019)	Rmb6.72
Deppon Logistics Co Ltd (603056.SS)	U (11/21/2018)	Rmb16.57
Guangshen Railway (0525.HK)	E (08/22/2018)	HK$1.58
Guangshen Railway (601333.SS)	U (10/30/2019)	Rmb2.57
Juneyao Airlines Co Ltd (603885.SS)	E (01/23/2019)	Rmb10.63
Kerry Logistics Network (0636.HK)	E (02/10/2020)	HK$12.24
Pacific Basin Shipping (2343.HK)	E (04/08/2020)	HK$1.23
S.F. Holding Co Ltd (002352.SZ)	O (07/08/2020)	Rmb66.40
Shanghai International Port Group Co Ltd (600018.SS)	U (10/15/2019)	Rmb4.59
Shenzhen International Holdings (0152.HK)	O (05/27/2014)	HK$13.22
Sinotrans Limited (0598.HK)	E (05/23/2019)	HK$1.66
SITC International Holdings Company (1308.HK)	O (03/25/2019)	HK$9.06
Spring Airlines (601021.SS)	O (08/31/2015)	Rmb44.42
STO Express Co Ltd (002468.SZ)	U (11/26/2019)	Rmb16.56
TravelSky Technology (0696.HK)	O (04/21/2020)	HK$15.62
YTO Express Group Co Ltd (600233.SS)	U (04/02/2019)	Rmb14.96
YUNDA Holding Co Ltd (002120.SZ)	U (07/29/2020)	Rmb23.67
ZTO Express (ZTO.N)	O (11/21/2016)	US$33.66
Wei Fang		
Beijing Capital Int'l Airport (0694.HK)	U (08/24/2018)	HK$5.54
Guangzhou Baiyun Int'l Airport (600004.SS)	E (05/07/2019)	Rmb15.03
Hainan Meilan International Airport (0357.HK)	O (07/09/2020)	HK$46.90
Shanghai International Airport (600009.SS)	O (08/28/2015)	Rmb74.38
Shenzhen Airport Company (000089.SZ)	E (04/01/2019)	Rmb10.17

Stock Ratings are subject to change. Please see latest research for each company.

* Historical prices are not split adjusted.

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建筑：一建、二建、消防、造价
法考：主观题、客观题
多平台网课：涵盖职场、办公技能、编程、文案写作、情感心理、穿搭技巧、理财投资健身减肥摄影技术等优质内容
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两小时搞定毛概马原思修近代史纲	高数(微积分)+线性代数+概率论	素描 0 基础入门教程
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托福雅思备考资料	大学物理学科攻略合集	动漫自学教程
SCI 最全写作攻略	TEM4/TEM8 专四专八备考资料	教师资格证面试试讲万能模板
360 份精美简历模板	数学建模 0 基础从入门到精通	100 套快闪 PPT 模板
Vlog 制作最全攻略	超强 PR 模板	42 套卡通风 PPT 模板
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好用到极致的 PPT 素材	128 套中国风 PPT 模板	32 套 MBE 风格 PPT 模板
327 套水彩风 PPT 模板	295 套手绘风 PPT 模板	54 套毕业答辩专属 PPT
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163 套学术答辩 PPT 模板	53 套北欧风 PPT 模板	34 套温暖治愈系 PPT 模板
118 套国潮风 PPT 模板	30 套仙系古风 PPT	126 套黑板风 PPT 模板
114 套星空风格 PPT 模板	192 套欧美商务风 PPT 模板	42 套绚丽暈染风 PPT
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98 套森系 PPT 模板	25 套简约通用 PPT 模板	记忆力训练教程
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吉他自学教程（送 6000 谱）	钢琴自学教程（送 1000 谱）	区块链从入门到精通资料
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